



ARTICLES

Did Zarin Have a Tufts Day at a Casino Made Out of Kirby Lumber?

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INTRODUCTION

Under our income tax system, “gross income,” defined broadly, is the starting point of the tax base.¹ The Supreme Court has defined gross income as “undeniable accessions to wealth, clearly realized, and over which the taxpayers have com-

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¹ See I.R.C. § 61(a) (1988) (stating that gross income is all income from whatever source derived). Unless otherwise indicated, all citations to provisions codified in Title 26 of the United States Code (1988) will be cited herein as sections of the Internal Revenue Code (the “Code”).

plete dominion” (“accession to wealth”).² Therefore, any test or theory applied to determine whether a particular receipt is gross income should find gross income whenever a taxpayer realizes an accession to wealth. Any test or theory that does not find gross income in all such cases misses the mark.

The receipt of any type of economic benefit is potentially gross income. One such economic benefit is the discharge of a debt. The courts have developed three tests for determining whether a taxpayer has realized gross income from the discharge of debt. Each test addresses a different discharge of debt scenario. The three tests are: (1) the *Kirby Lumber* doctrine;³ (2) the “double deduction” rationale;⁴ and (3) the “loan proceeds” rationale.⁵

The courts have applied the *Kirby Lumber* doctrine when the creditor discharges debt for less than the outstanding balance of the debt (the “*Kirby Lumber* scenario”).⁶ In the *Kirby Lumber* scenario, the taxpayer realizes gross income to the extent that her net worth is increased by freeing assets otherwise required to satisfy the forgiven portion of the debt.⁷ In contrast, the courts have applied the double deduction rationale when the taxpayer transfers acquisition nonrecourse debt securing property that is worth less than the outstanding balance of the debt to the lender or a third party in full satisfaction of that debt (the “double deduction scenario”).⁸ Finally, the courts have applied the loan proceeds rationale when the taxpayer transfers nonacquisition nonrecourse debt securing property to the lender in full satisfaction of the debt (the “loan proceeds scenario”).⁹

² Commissioner v. Glenshaw Glass, 348 U.S. 426, 431 (1955).

³ See United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931); see also United States v. Centennial Sav. Bank FSB, 111 S. Ct. 1512, 1518 (1991); Estate of Delman v. Commissioner, 73 T.C. 15, 32 (1979).

⁴ See Millar v. Commissioner, 577 F.2d 212, 215 (3d Cir.), cert. denied, 439 U.S. 1046 (1978).

⁵ See Commissioner v. Tufts, 461 U.S. 300, 301-10 (1983).

⁶ See, e.g., Helvering v. American Chicle Co., 291 U.S. 426 (1934) (taxing as income gain realized from discharge of debt).

⁷ Sutphin v. United States, 14 Cl. Ct. 545, 547 (1988); Zappo v. Commissioner, 81 T.C. 77, 85-86 (1983).

⁸ Tufts v. Commissioner, 70 T.C. 756, 768 (1978), rev'd, 651 F.2d 1058 (5th Cir. Unit A July 1981), rev'd, 461 U.S. 300 (1983) (citing cases).

⁹ Mendham Corp. v. Commissioner, 9 T.C. 320, 323-24 (1947); Lutz & Schramm Co. v. Commissioner, 1 T.C. 682, 688-89 (1943). The loan proceeds scenario differs from the double deduction scenario because in the loan proceeds scenario, the nonrecourse debt is nonacquisition debt. Such debt is not included in the basis of the secured property, as acquisition debt

The *Kirby Lumber* doctrine and the double deduction rationale are deficient because they do not always find gross income when the taxpayer realizes an accession to wealth from the discharge of debt. When these rationales fail, it is because they do not take into account that if the taxpayer does not include as gross income the tax-free receipt of loan proceeds that will never be repaid as a result of discharge, this income will forever escape taxation. In contrast, the loan proceeds rationale correctly finds gross income in every type of discharge of debt scenario, including every *Kirby Lumber* and double deduction scenario. This is because the loan proceeds rationale focuses on the tax-free use of the loan proceeds during the term of the loan, and ties realization of gross income to an event that cancels the taxpayer's promise to repay the loan.

Two court decisions illustrate judicial adoption of the loan proceeds rationale in place of the double deduction rationale and the *Kirby Lumber* doctrine. In the first case, *Commissioner v. Tufts*,¹⁰ the Supreme Court replaced the double deduction rationale with the loan proceeds rationale by applying the loan proceeds rationale to a double deduction scenario case.¹¹ The second case, *Zarin v. Commissioner*,¹² involved the discharge of an unenforceable, unsecured debt for an amount less than the debt's outstanding balance. Under the *Kirby Lumber* doctrine, there would have been no gross income.¹³ The Tax Court, however, relying on the *Tufts* decision, applied the loan proceeds rationale to find gross income.¹⁴

would be included in the basis of the secured property, because such debt is not incurred to acquire or improve the secured property. In the loan proceeds scenario, the borrowed funds are used for other purposes. See, e.g., *Mendham Corp.*, 9 T.C. at 323 (stating that taxpayer received loan proceeds "to do with as it pleased, free from restriction.").

¹⁰ 461 U.S. 300 (1983).

¹¹ See *id.* at 310-12.

¹² 92 T.C. 1084 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990).

¹³ In *Zarin*, the taxpayer argued that the discharge of an unenforceable debt did not result in gross income because the debt never encumbered his assets; thus, the discharge did not free those assets. *Id.* at 1090. In his dissent, Judge Tannenwald agreed with the taxpayer's argument and contended that the discharge did not create gross income under the *Kirby Lumber* doctrine. *Id.* at 1103.

¹⁴ *Id.* at 1091-94. The Tax Court's *Zarin* opinion was the inspiration for the title of this Article, "Did *Zarin* Have a *Tufts* Day at a Casino Made Out of *Kirby Lumber*?" Stated differently, the title might read, "Did the Tax Court Apply the Loan Proceeds Rationale of the Supreme Court's *Tufts* Decision

Further, the soundness of the loan proceeds rationale extends beyond its success in finding gross income in each discharge of debt scenario in which the taxpayer realizes an accession to wealth. The loan proceeds rationale also provides justification for the long established tax principle that the basis of acquired property includes acquisition nonrecourse debt.¹⁵

Despite the Supreme Court's and the Tax Court's rejection of the double deduction rationale and the *Kirby Lumber* doctrine, respectively, the *Tufts* and *Zarin* cases fail to explain adequately the deficiencies of these two tests.¹⁶ This Article traces the development of the *Kirby Lumber* doctrine and the double deduction rationale and identifies their deficiencies. The Article also tracks the development of the loan proceeds rationale and illustrates how it successfully finds gross income in each of the three discharge of debt scenarios in which a taxpayer realizes an accession to wealth. Finally, the Article explains how the loan proceeds rationale justifies the inclusion of acquisition nonrecourse debt in the basis of the acquired property.

I. THE *KIRBY LUMBER* DOCTRINE

The *Kirby Lumber* scenario involves a debt satisfied for an amount less than the outstanding balance of the debt.¹⁷ Under the *Kirby Lumber* doctrine, such a discharge creates "income from discharge of indebtedness" ("DOI") under section 61(a)(12) of

to Find Gross Income in a Discharge of Debt Scenario in which the *Kirby Lumber* Doctrine Would Have Found None?"

The Third Circuit's reversal of the Tax Court's *Zarin* decision, however, leaves open the question of whether the application of the loan proceeds rationale to a similar case will be accepted or rejected. *See infra* note 68 (discussing Third Circuit's *Zarin* decision).

¹⁵ *See* *Crane v. Commissioner*, 331 U.S. 1, 11 (1947); *Odend'hal v. Commissioner*, 748 F.2d 908, 912 (4th Cir. 1984), *cert. denied*, 471 U.S. 1143 (1985).

¹⁶ In *Tufts*, the Court did not expressly reject the double deduction rationale; instead, it noted in footnote 10 that because the Court had resolved the issue on other grounds, it need not address the validity of the double deduction rationale. *Commissioner v. Tufts*, 461 U.S. 300, 310 n.10 (1983). In *Zarin*, the Tax Court concluded that the Supreme Court's *Tufts* decision dictated the inclusion of the amount of the taxpayer's debt relief in gross income. The Tax Court's analysis did not, however, address the deficiencies of the *Kirby Lumber* doctrine. *See Zarin*, 92 T.C. at 1091-94.

¹⁷ *United States v. Kirby Lumber Co.*, 284 U.S. 1, 2 (1931).

the Internal Revenue Code of 1986 (the "Code").¹⁸ The premise of DOI is that a discharge of debt for an amount less than its outstanding balance increases the taxpayer's net worth by the amount of the debt that is forgiven.¹⁹ Discharge of debt accomplishes this result by freeing assets otherwise required to satisfy the forgiven portion of the debt. The debtor's net worth thus increases because her debt decreases without a corresponding decrease in her assets. The increase in net worth is "an accession to income."²⁰ This rationale is known as the "freeing of assets" or the "net worth" theory.²¹

A. Development of the Kirby Lumber Doctrine

1. The *Empire* Strikes First

To understand the development of the *Kirby Lumber* doctrine, one must trace its origin back to *Bowers v. Kerbaugh-Empire Co.*²² In *Kerbaugh-Empire*, a corporation repaid a foreign currency loan at an exchange rate lower than the exchange rate in effect at the time of borrowing.²³ Thus, the corporation satisfied the debt for fewer United States dollars at the time of repayment than it would have at the time of borrowing. The issue was whether this transaction generated taxable income.

In *Kerbaugh-Empire*, between 1911 and 1913, a corporation borrowed from the Deutsche Bank of Germany (the "Bank") 8,341,337.50 Deutsche marks ("DMs"), or the equivalent of \$1,983,000.²⁴ The loan was repayable in DMs or their equivalent

¹⁸ See I.R.C. § 61(a)(12). In *Sutphin v. United States*, 14 Cl. Ct. 545 (1988), the court summarized the historical development of the general rule that gross income includes discharge of indebtedness:

In *United States v. Kirby Lumber Co.*, the Supreme Court announced the general rule that gross income includes income from the discharge of indebtedness. Section 61(a) of the Internal Revenue Code of 1954 adopts this holding and defines gross income as "all income from whatever source derived." Section 61(a)(12) provides that gross income includes amounts received from the discharge of indebtedness.

Id. at 547 (citation omitted) (footnote omitted).

¹⁹ *Sutphin*, 14 Cl. Ct. at 547; *Zappo v. Commissioner*, 81 T.C. 77, 85-86 (1983).

²⁰ *Kirby Lumber*, 284 U.S. at 3.

²¹ See *Madison Rys. v. Commissioner*, 36 B.T.A. 1106, 1109 (1937).

²² 271 U.S. 170 (1926).

²³ *Id.*

²⁴ *Id.* at 171-72.

in United States gold coin.²⁵ The corporation, in turn, loaned the money to a wholly owned subsidiary. The subsidiary, however, lost the entire amount over the next several years.²⁶

In 1921, the remaining outstanding principal amount of the loan was 3,216,445 DMs.²⁷ Due to a large drop in the exchange rate, the corporation repaid the outstanding balance of the loan for \$80,411.12.²⁸ Based upon the exchange rate in effect when the corporation borrowed the money, however, 3,216,445 DMs was the equivalent of \$764,867.30.²⁹ The corporation thus saved \$684,456.18.

The Government argued that the savings that the corporation realized by repaying the loan at the more favorable exchange rate generated a taxable gain.³⁰ The Government noted that upon receipt of the borrowed money, both the corporation's assets and its liabilities increased by \$764,867.30.³¹ Due to the lower exchange rate at the time of repayment, however, the corporation was able to extinguish the original liability of \$764,867.30 by decreasing its assets by only \$80,411.12. In the Government's view, the resulting increase in net worth of \$684,456.18 represented profit to the corporation.³² Therefore, under a broad and comprehensive concept of income, the profit was taxable gross income.³³

The Supreme Court rejected the Government's argument and held that repayment of the loan at the lower exchange rate was not taxable income for two reasons. First, the gain realized from repayment of the loan did not fit within the Supreme Court's narrow definition of income.³⁴ Second, there could not be any gain

²⁵ *Id.* at 172.

²⁶ *Id.*

²⁷ *See id.* at 172-73.

²⁸ *Id.* at 173.

²⁹ Brief on Behalf of Plaintiff In Error at 4, *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926) (No. 173).

³⁰ *Id.* at 7.

³¹ *Id.* at 11.

³² *Id.* at 7.

³³ *Id.*

³⁴ *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 174-75 (1926). The Supreme Court focused on its earlier decisions that also addressed the issue of what is income. In those cases, the Supreme Court defined "income" as "gain derived from capital, from labor, or from both combined, including profit gained through sale or conversion of capital." *Id.* at 174 (citations omitted).

in any event because the borrower ultimately lost all of the loan proceeds.³⁵

The Supreme Court's conclusion that the loss of the loan proceeds precluded a finding of gross income countered the Government's net worth argument. The Court's reasoning was crucial for the development of the *Kirby Lumber* doctrine.³⁶ Contrary to the Government's view, the Court concluded that the corporation's net worth had decreased. At the time of the loan, the corporation increased its assets and liabilities by the amount of the borrowed funds. The Court reasoned that when the corporation subsequently lost the funds, its assets decreased without a corresponding decrease in its liabilities.³⁷ As a result, the corporation's net worth decreased. When the corporation later repaid the loan at a more favorable exchange rate, the corporation's assets and net worth further diminished.³⁸ The Court thus found that the savings generated by repaying the loan at a more favorable exchange rate merely lessened the decrease in net worth caused by the loss of the borrowed funds.³⁹

In *Kerbaugh-Empire*, the Supreme Court proffered a flawed analysis of the issue. The Court's analysis ignored the corporation's tax-free use of the loan proceeds during the term of the loan. The loss of the loan proceeds was irrelevant to the question of whether the money saved from repayment of the loan at a more favorable exchange rate was gross income.

For tax purposes, income is computed on an annual basis, accounting for the net result of all of the taxpayer's transactions during a twelve-month period.⁴⁰ In *Burnet v. Sanford & Brooks Co.*,⁴¹ the Supreme Court held that amounts received pursuant to a contract in one year are gross income for that year, despite the fact that the taxpayer suffered net losses attributable to that con-

³⁵ *Id.* at 175.

³⁶ See *infra* notes 44-53 and accompanying text (discussing *Kirby Lumber* doctrine). The first rationale based upon a narrow view of the definition of income was rejected by the Supreme Court in *Kirby Lumber*. See *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931).

³⁷ This analysis ignores the fact that the corporation reloaned the funds to its subsidiary, thereby creating a receivable in that amount payable from the subsidiary to the corporation. Thus, the subsidiary, not the corporation, lost the borrowed money.

³⁸ *Kerbaugh-Empire*, 271 U.S. at 175.

³⁹ *Id.*

⁴⁰ See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931).

⁴¹ *Id.*

tract in an earlier year.⁴² Similarly, in *Kerbaugh-Empire*, the loss of the loan proceeds did not negate the fact that the corporation enjoyed the tax-free use of those proceeds during the term of the loan. Thus, if a corporation need not include in income the amount saved pursuant to repayment at a more favorable exchange rate, it will receive an economic windfall that will never be taxed.⁴³

2. The Kirby Lumber Case

Several years after *Kerbaugh-Empire*, the Government persuaded the Supreme Court to accept the net worth argument in *United States v. Kirby Lumber Co.*⁴⁴ In July 1923, Kirby Lumber issued bonds for \$12,126,800.⁴⁵ Later that year, it purchased some of those bonds on the open market for \$137,521.30 less than their issue price.⁴⁶ The issue was whether Kirby Lumber recognized income because of the discharge of its debt for an amount less than the debt's outstanding balance.

In *Kirby Lumber*, the Government reasserted its *Kerbaugh-Empire* argument that repayment of a debt resulting in an increase of the debtor's net worth creates taxable income.⁴⁷ In the course of its decision, the Court noted that when Kirby Lumber retired some of the same bonds, Kirby Lumber increased its assets and net worth by \$137,521.30.⁴⁸ The issue was whether the net worth increase created a taxable gain.⁴⁹

The Court distinguished *Kirby Lumber* from *Kerbaugh-Empire*

⁴² *Id.* at 364. In *Kerbaugh-Empire*, the Government noted in its brief that "[t]here is neither an actual nor a constructive carving of the tax out of any fund identified as income. Nor can collection of the tax, once it is determined, be defeated by investment, theft or destruction. It is enough that it was realized as income during the year." Brief on Behalf of Plaintiff in Error at 13, *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926) (No. 173).

⁴³ In *Sanford & Brooks*, the Supreme Court distinguished *Kerbaugh-Empire* on the basis that the corporation in the latter case did not receive any money as a result of repayment. *Sanford & Brooks*, 282 U.S. at 364. This distinction, however, fails to take into account the loan proceeds enjoyed tax-free by the corporation during the loan term.

⁴⁴ 284 U.S. 1 (1931).

⁴⁵ *Id.* at 2.

⁴⁶ *Id.*

⁴⁷ *See id.* at 3.

⁴⁸ *Id.*

⁴⁹ *Id.* at 2.

based on the overall gain that Kirby Lumber realized.⁵⁰ In *Kerbaugh-Empire*, the corporation lost all of the borrowed funds over a period of several years. Therefore, despite the increase in the corporation's assets attributable to the loan proceeds, those assets actually decreased as a result of the loss. The Court thus reasoned that there was no gain in the year of the discounted repayment of the debt.⁵¹ In *Kirby Lumber*, however, the taxpayer clearly realized an overall gain from repayment of the bonds for less than their face amount.⁵² The Supreme Court accepted the Government's argument and held that the gain was taxable.⁵³

Ironically, the Government scored a hollow victory in the *Kirby Lumber* case. The Court distinguished *Kirby Lumber* from *Kerbaugh-Empire* based on Kirby Lumber's overall gain in the transaction at issue. Thus, the Government became vulnerable to losing cases in which repayment of debt at a discount did not result in an overall gain or increase the taxpayer's net worth.

B. Judicial and Statutory Exceptions to Kirby Lumber

The *Kirby Lumber* doctrine finds DOI when repayment of a debt for less than its outstanding balance increases a debtor's net worth by freeing assets otherwise required to satisfy the forgiven debt. Some courts have limited application of the *Kirby Lumber* doctrine to cases in which discharge of debt increases or creates a positive net worth by freeing the debtor's assets.⁵⁴ The following example illustrates this limitation of the *Kirby Lumber* doctrine.

Assume that an insolvent debtor has assets of \$100 and liabilities of \$200, resulting in a negative net worth of \$100 [assets (\$100) minus liabilities (\$200) equals net worth (-\$100)]. If the debtor is discharged of \$50 of debt, her net worth remains negative [assets (\$100) minus liabilities (\$150) equals net worth (-\$50)]. Thus, the discharge has not freed any of her assets because both before and after the discharge, all of her assets (\$100) remain subject to her creditors' claims.

⁵⁰ *Id.* at 3; see *supra* notes 35-39 and accompanying text (discussing Court's rationale in *Kerbaugh-Empire* that there could be no taxable gain because taxpayer's net worth decreased).

⁵¹ *Kirby Lumber*, 284 U.S. at 3.

⁵² *Id.*

⁵³ *Id.*

⁵⁴ See, e.g., *Estate of Newman v. Commissioner*, 934 F.2d 426 (2d Cir. 1991); *Madison Rys. v. Commissioner*, 36 B.T.A. 1106 (1937); *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289 (1937).

Similarly, if the debtor in the above example is discharged of \$150 of debt, she becomes solvent by \$50 because the discharge creates a positive net worth of \$50 [assets (\$100) minus liabilities (\$50) equals net worth (\$50)]. Although \$150 of debt was discharged, the discharge only freed \$50 of assets. Before the discharge, all of the debtor's assets were subject to her creditors' claims; after the discharge, only \$50 of her assets were subject to her creditors' claims.

Based upon the theory that a taxpayer realizes DOI only to the extent that her positive net worth is increased or created, some courts have carved out exceptions to the *Kirby Lumber* doctrine. Thus, when an insolvent debtor's debt is discharged, DOI is triggered only to the extent that the discharge rendered the debtor solvent.⁵⁵

*Lakeland Grocery Co. v. Commissioner*⁵⁶ illustrates such an exception to the *Kirby Lumber* doctrine. *Lakeland Grocery* involved a *Kirby Lumber* scenario in which the debtor was insolvent. The debtor satisfied a \$104,710.16 debt for \$15,472.61, or a total discharge of \$89,237.55.⁵⁷ As a result of the discharge, however, the debtor became solvent by only \$39,596.93.⁵⁸ Although the total discharge exceeded the amount by which the debtor became solvent, the Board of Tax Appeals reasoned that the discharge freed the debtor's assets only to the extent of its solvency.⁵⁹ Thus, the Board limited the recognition of DOI to \$39,596.93.⁶⁰

*Madison Railways Co. v. Commissioner*⁶¹ provides another example of how the courts have limited application of the *Kirby Lumber* doctrine. *Madison* concerned an insolvent debtor that remained insolvent after retiring its bonds at a discount. Consistent with *Lakeland Grocery*, the Board of Tax Appeals held that the debtor did not recognize income because the debtor's net worth remained negative.⁶² The Board reasoned that the discharge did not free any of the debtor's assets or increase its net worth.⁶³ Thus, because both before and after the discharge all of the

⁵⁵ See sources cited *supra* note 54.

⁵⁶ 36 B.T.A. 289 (1937).

⁵⁷ See *id.* at 290.

⁵⁸ See *id.*

⁵⁹ *Id.* at 292.

⁶⁰ *Id.*

⁶¹ 36 B.T.A. 1106 (1937).

⁶² *Id.* at 1109.

⁶³ *Id.*

debtor's assets remained subject to creditors' claims, the debtor did not realize DOI from the discharge.

Congress has also limited the *Kirby Lumber* doctrine's applicability in the case of an insolvent debtor. Several years after the *Kirby Lumber* decision, "which in the midst of the depression loosed the tax collector against debtors discharging their debts at a discount,"⁶⁴ Congress provided debtors partial relief from inclusion of DOI in gross income by enacting the Chandler Act of 1938⁶⁵ and the Revenue Act of 1939.⁶⁶ More recently, Congress in 1980 codified an exclusion from gross income for DOI realized by an insolvent debtor.⁶⁷ By codifying this exclusion, Congress acknowledged the validity of both the *Kirby Lumber* doctrine⁶⁸ and

⁶⁴ Norris Darrell, *Discharge of Indebtedness and the Federal Income Tax*, 53 HARV. L. REV. 977, 977 (1940).

⁶⁵ Bankruptcy Act of 1938, ch. 575, 52 Stat. 840, 904, 915, 929, 938 (1938) (ch. 10, §§ 268-270; ch. 11, §§ 395-396; ch. 12, §§ 520-522; ch. 13, § 679).

⁶⁶ I.R.C. § 22(b)(9) (1939); Revenue Act of 1939, ch. 247, § 215, 53 Stat. 862, 875 (1939). In general, under certain circumstances, this section provided an exclusion of DOI from gross income. The section was retained in the Internal Revenue Code of 1954 as § 108.

⁶⁷ I.R.C. § 108(a)(1)(B), added by the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2(a), 94 Stat. 3389 (1980). However, this exception does not apply to the extent a debtor becomes solvent as a result of the DOI. I.R.C. § 108(a)(3). The term "insolvent" is defined as the excess of liabilities over the fair market value of assets. I.R.C. § 108(d)(3). Section 108(a)(1)(B) reads as follows:

(a) EXCLUSION FROM GROSS INCOME.—

(1) IN GENERAL.—Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if . . . (B) the discharge occurs when the taxpayer is insolvent

I.R.C. § 108(a)(1)(B).

⁶⁸ *Zarin* offered a strange twist to the *Kirby Lumber*-§ 61(a)(12)-§ 108 connection. See *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990), *rev'g* 92 T.C. 1084 (1989). In *Zarin*, the taxpayer satisfied a \$3.4 million unenforceable gambling debt for \$500,000. The Tax Court held that the taxpayer realized DOI in the amount of \$2.9 million under § 61(a)(12) of the Code. See *infra* notes 218-37 and accompanying text (discussing Tax Court's *Zarin* opinion). In reversing the Tax Court, the Third Circuit did not apply the *Kirby Lumber* doctrine. Because an unenforceable debt cannot be satisfied from a taxpayer's assets, the taxpayer's assets would not be freed by the discharge of that debt. Thus, under the *Kirby Lumber* doctrine, the taxpayer would not have realized DOI.

Instead of applying the *Kirby Lumber* doctrine to reverse the Tax Court,

the judicially developed insolvency exception.⁶⁹

II. THE *CRANE* DOCTRINE AND THE DOUBLE DEDUCTION RATIONALE

A. *Origins of the Crane Doctrine and Explanation of the Double Deduction Rationale*

The double deduction rationale evolved from footnote 37 of the Supreme Court's decision in *Crane v. Commissioner*.⁷⁰ The double deduction scenario involves the disposition of property subject to acquisition nonrecourse debt greater than the property's fair market value.⁷¹ In the typical double deduction scenario, a taxpayer acquires property with a fair market value about equal to the nonrecourse debt securing the property.⁷² Later, at a time when the property's value falls below the balance of the debt, the taxpayer transfers the property subject to the debt to the lender or a third party in full satisfaction of the debt. The

the Third Circuit searched for a definition of indebtedness for purposes of § 61(a)(12) of the Code. It found a definition of the term "indebtedness" in § 108(d)(1) of the Code. See *Zarin*, 916 F.2d at 113. Subsection (d)(1)(A) defines the term as any indebtedness for which the taxpayer is liable. See I.R.C. § 108(d)(1)(A). The court then applied this definition of the term indebtedness to § 61(a)(12) of the Code. See *Zarin*, 916 F.2d at 113. The court determined that the taxpayer did not realize DOI from the discharge of an unenforceable gambling debt because he was not liable for the debt under New Jersey state law. *Id.*

The Third Circuit's approach to the DOI issue in *Zarin* leaves open the question of whether the Third Circuit has determined that the *Kirby Lumber* doctrine has been superseded by § 108 of the Code. At a minimum, the Third Circuit's opinion challenges the Tax Court's application of the loan proceeds theory to DOI cases.

⁶⁹ S. REP. NO. 96-1035, 96th Cong., 2d Sess. 2-4 (1980), reprinted in 1980 U.S.C.C.A.N. 7017, 7017-19. In spite of this exclusion, § 108(a)(1)(B) of the Code is not a total codification of the judicially developed insolvency exception to DOI. According to the judicial insolvency exception, there is no DOI at all if a debt discharge did not cause the debtor to become solvent. Under § 108(b) of the Code, however, the debtor must reduce certain of its tax attributes in exchange for the exclusion. If an insolvent debtor does not have DOI, as the judicial insolvency exception indicates, there should be no need to reduce tax attributes in exchange for the exclusion.

⁷⁰ 331 U.S. 1, 14 n.37 (1947). Footnote 37 states that if the property value is less than the mortgage amount, a mortgagor who is not personally liable cannot realize a benefit that equals the mortgage. *Id.*

⁷¹ See, e.g., *Tufts v. Commissioner*, 70 T.C. 756 (1978), rev'd, 651 F.2d 1058 (5th Cir. Unit A July 1981), rev'd, 461 U.S. 300 (1983).

⁷² See, e.g., *id.* at 758.

decline in the property's fair market value reflects an economic loss with respect to the property.⁷³ That economic loss is not, however, actually suffered by the taxpayer, because the taxpayer has not paid the original acquisition nonrecourse debt, and after transferring the secured property, will never be required to repay that debt.⁷⁴

Because the double deduction scenario involves the disposition of property, the courts have applied section 1001 of the Code to compute gain or loss.⁷⁵ The issue is whether the amount realized on the disposition includes the entire balance of the nonrecourse debt or only the fair market value of the property. The courts have held that the amount realized includes the full amount of the nonrecourse debt.⁷⁶ Otherwise, the taxpayer would receive double deductions.

The first set of deductions consists of depreciation deductions. These deductions are allowed because the depreciable basis of the property includes the entire amount of the nonrecourse debt.⁷⁷ If basis does not include the debt, the taxpayer's depreciable basis in the property will be limited to her cash payments to the seller.⁷⁸ In that event, if the taxpayer only makes a nominal cash down payment on the property, her basis and corresponding depreciation deductions will also be nominal. Because the basis of the property includes the entire amount of the acquisition nonrecourse debt, however, she receives the benefit of depreciation deductions equal to the cost of the property that she will eventually pay when she satisfies the debt. In retrospect, the deprecia-

⁷³ See, e.g., *id.* at 764.

⁷⁴ See, e.g., *id.* at 765.

⁷⁵ Section 1001(a) of the Code provides:

COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

I.R.C. § 1001(a); *cf.* *Millar v. Commissioner*, 577 F.2d 212, 215 (3d Cir.) (applying double deduction rationale to situation in which secured property disposed of was stock of Subchapter S corporation), *cert. denied*, 439 U.S. 1046 (1978).

⁷⁶ See *Crane v. Commissioner*, 331 U.S. 1, 16 (1947); *Millar*, 577 F.2d at 215.

⁷⁷ *Crane*, 331 U.S. at 9; *Millar*, 577 F.2d at 215.

⁷⁸ See Treas. Reg. § 1.1012-1(a) (as amended in 1980).

tion deductions taken with respect to the inclusion of nonrecourse debt in the taxpayer's basis would be unwarranted to the extent that she did not pay the debt.

The taxpayer will be entitled to a second deduction if, upon disposition of the property, the amount realized is limited to the property's fair market value. This deduction will result from the fact that the property's fair market value reflects the economic decline in its value that occurs between the time the taxpayer initially acquires it and the time she subsequently disposes of it. The taxpayer does not, however, actually suffer that economic loss because she did not pay the original acquisition nonrecourse debt; further, after transferring the property, she will never have to repay that debt.

It is the transferee who ultimately suffers the economic loss on the property because the outstanding amount of the debt exceeds the property's fair market value. If the transferee is the original lender, she must take the devalued property in lieu of the greater amount of money owed to her. If the transferee is a third party, she must pay a debt greater than the property's value in order to retain ownership of the property. Thus, if the amount realized were limited to the property's fair market value, thus reflecting the economic decline in its value, the taxpayer would be able to take an unwarranted loss or reduction of gain from the disposition of the property.

The double deduction rationale requires the taxpayer who has suffered no economic loss from the secured property to recapture the depreciation deductions she was able to take by including the debt in the basis of the property. The rationale also eliminates the possibility that the taxpayer might take a further unrealized loss or reduced gain on the disposition of the economically devalued property. The double deduction rationale achieves these results by requiring the transferee to include the outstanding balance of the nonrecourse debt in the amount realized on the disposition of the property. Instead of reducing the gain or creating a loss transaction, as would result if the amount realized only included the property's fair market value, the taxpayer will always realize a gain.⁷⁹ In addition, because the gain will equal the

⁷⁹ There will always be a gain because the amount realized will always exceed the adjusted basis of the property. See I.R.C. § 1001(a). This is because the amount realized includes the outstanding balance of the acquisition nonrecourse debt, and the adjusted basis of the secured

amount of the previously allowed depreciation deductions, it will offset the prior unwarranted depreciation deductions.

To illustrate this point, assume that the taxpayer acquires property with a fair market value of \$100, financed entirely with acquisition nonrecourse debt encumbering the property. During the entire period of the taxpayer's ownership of the property, she makes no payments on the debt. When the property's fair market value has decreased to \$20 and its adjusted basis has decreased to \$50 due to allowable depreciation deductions, the taxpayer conveys the property to the lender in full satisfaction of the nonrecourse debt. If the amount realized includes only the property's fair market value, the disposition of this property would result in a \$30 tax loss to the taxpayer [fair market value (\$20) minus adjusted basis (\$50) equals loss (\$-30)].⁸⁰ In addition, the taxpayer had previously claimed a total of \$50 in depreciation deductions that she used to offset other income. Thus, in total, the taxpayer would have an aggregate tax loss of \$80. The taxpayer has not suffered a real economic loss, however, from any economic decline in the value of the property because she has invested nothing in the property. The lender, not the taxpayer, suffers the \$80 economic loss because the lender must take the devalued property worth \$20 in lieu of the \$100 it loaned the taxpayer.

The double deduction theory eliminates the taxpayer's double deductions by requiring her to include the full outstanding balance of the debt in the amount realized on the disposition of the secured property. Thus, the taxpayer's amount realized on the disposition of the property is \$100, the balance of the debt. Because the taxpayer's adjusted basis in the property is \$50, she realizes a gain of \$50 [amount realized (\$100) minus adjusted basis (\$50) equals gain (\$50)].⁸¹ This realization of gain eliminates the \$30 unwarranted loss on the disposition of the property. In addition, the \$50 gain offsets the taxpayer's prior depreciation deductions in the same amount. Thus, the net result

property is the original acquisition nonrecourse debt less all of the prior years' depreciation deductions. *See* I.R.C. § 1016(a)(2). Thus, under § 1001(a) of the Code, the taxpayer always realizes a gain when the amount realized exceeds the adjusted basis of the property. *See* I.R.C. § 1001(a).

⁸⁰ *See* I.R.C. § 1001(b).

⁸¹ *See* I.R.C. § 1001(a).

to the taxpayer is a zero tax benefit from the prior depreciation deductions.⁸²

B. *The Crane Case*

In *Crane v. Commissioner*,⁸³ the taxpayer sold real property (an apartment building and the underlying land) subject to acquisition nonrecourse debt to a third party.⁸⁴ In addition to release of the mortgage obligation, she received the net amount of \$2,500 in cash.⁸⁵ In computing her gain, one issue was whether the taxpayer's amount realized, as defined by the predecessor to section 1001(b) of the Code, included the nonrecourse debt relief.⁸⁶ Section 1001(b) defines "amount realized" as "the sum of any money received."⁸⁷ The taxpayer in *Crane* did receive money as part of the consideration. The issue, however, was whether to treat the nonrecourse debt relief as the receipt of money.⁸⁸

The Supreme Court held that the amount realized included the

⁸² If the underlying property was real property and the taxpayer claimed straight line depreciation deductions, the taxpayer might, however, potentially benefit from the offset. The depreciation deductions taken in the prior years were ordinary deductions, and thus, offset other ordinary income. The gain recognized on the disposition of the underlying property would be gain under § 1231, and thus potentially long term capital gain because straight line depreciation taken with respect to real property is not subject to recapture as ordinary income under § 1250 of the Code. See I.R.C. §§ 1231, 1250. Therefore, the taxpayer could potentially receive a benefit to the extent of the rate differential between long term capital gain and ordinary income. See I.R.C. § 1(h). In other words, the taxpayer's tax savings realized by taking a deduction against ordinary income may be potentially greater than the additional amount of tax triggered by the long term capital gain on the disposition of the property.

In addition, even assuming no rate differential between ordinary income and long term capital gain, the taxpayer could potentially benefit from the offset. A deduction that saves the taxpayer tax dollars in an earlier year is like an interest free loan which the taxpayer "pays back" when, in a later year, she must offset the amount of the prior deduction by including that amount in gross income.

⁸³ 331 U.S. 1 (1947).

⁸⁴ *Id.* at 3.

⁸⁵ *Id.*

⁸⁶ *Id.* at 12.

⁸⁷ I.R.C. § 1001(b). Section 1001(b) states in relevant part: "AMOUNT REALIZED.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." *Id.*

⁸⁸ *Crane*, 331 U.S. at 13-14.

debt relief.⁸⁹ In support of this position, the Court cited several decisions that interpreted the term “money” as used in other Code sections to include debt relief.⁹⁰ Those courts refused to interpret the term “money” in a way that would lead either to an absurd result or to one that was contrary to the statute’s meaning as a whole.⁹¹

⁸⁹ *Id.* at 13.

⁹⁰ *Id.* In *United States v. Hendler*, 303 U.S. 564, 566 (1938), one of the cases cited by the Court, the Supreme Court held that liability relief pursuant to a tax-free reorganization was the equivalent of the receipt of cash. Similarly, in *Brons Hotels, Inc. v. Commissioner*, 34 B.T.A. 376, 381-82 (1936), the Board of Tax Appeals held that consideration in the form of liability relief pursuant to a like-kind exchange was to be treated as “money.”

⁹¹ See sources cited *supra* note 90. The Court also cited *Brons Hotels*, 34 B.T.A. at 381-82, a case that involved a like-kind exchange under the predecessor to § 1031 of the Code. In that case, the taxpayer exchanged real property subject to a mortgage (the “exchanged property”) for an apartment building (the “replacement property”), cash, and the assumption of the mortgage by the transferee. *Id.* at 377. The taxpayer conceded that its realized gain should be computed by including the debt relief as part of the consideration received. *Id.* at 379. The taxpayer argued that for purposes of computing its recognized gain under the predecessor of § 1031(b) of the Code, only the cash received was boot. In support of this position, the taxpayer contended that the phrase “money or other property,” which is treated as boot under § 1031(b) of the Code, should be read literally. *Id.*

The Board of Tax Appeals rejected this literal reading of the word “money” under § 1031(b) because it would lead to an absurd result for purposes of computing the taxpayer’s basis in the replacement property under the predecessor of § 1031(d) of the Code. *Id.* at 381-82. Under § 1031(d), the basis in replacement property received in a like-kind exchange is the same as the taxpayer’s basis in the exchanged property, less the amount of any money received. See I.R.C. § 1031(d). On the facts of the case, if the word “money” were interpreted literally and did not include debt relief, the taxpayer’s basis in the replacement property would be the same as its basis in the exchanged property. Therefore, the taxpayer’s basis in the replacement property would not be reduced by the amount of the debt relief. The court noted that when the taxpayer had originally acquired the exchanged property, “it received, as part of its [basis], the benefit of the mortgage which it assumed” *Brons Hotels*, 34 B.T.A. at 379. The mortgage debt that was part of the taxpayer’s basis in the exchanged property, however, was not an encumbrance on the replacement property. As a result of the failure to reduce the taxpayer’s basis in the replacement property by the mortgage assumed by the transferee, the taxpayer would have an improperly inflated basis in the replacement property. Therefore, upon a subsequent taxable disposition of the replacement property, the

All of the cited cases, however, involved recourse debt relief.⁹² Recourse debt is enforceable against all of a taxpayer's assets.⁹³ Thus, if the value of the property securing the recourse debt is not sufficient to satisfy the debt, the creditor may attach the taxpayer's other assets for payment. Debt relief in this context is therefore equivalent to the debtor receiving the amount of money that she would have been compelled to pay the creditor to satisfy the debt.

In contrast, nonrecourse debt is enforceable only against the property securing the debt.⁹⁴ Therefore, the taxpayer's liability is limited to repossession of the property securing the debt. If the value of the property securing the debt does not equal the balance of the debt, the taxpayer is not obligated to repay the debt beyond surrendering the secured property to the lender. It is thus impossible for the taxpayer to receive an economic benefit that exceeds the property's value because she has no obligation to repay that amount.

On the facts of the *Crane* case, the Supreme Court was able to overcome the distinction between nonrecourse and recourse debt relief. The Court concluded that the taxpayer's nonrecourse debt relief was economically equivalent to recourse debt relief because she also received cash. The Court reasoned that whether the debt was recourse or nonrecourse, the net result was as if the buyer had paid the full consideration in cash to the taxpayer, who then paid off the debt and kept the rest of the cash for herself.⁹⁵ The Supreme Court further reasoned that just as any recourse debt is a personal debt of the taxpayer, a taxpayer who owns property worth more than a secured nonrecourse debt will treat that debt as a personal debt.⁹⁶ Such a taxpayer will have an economic incentive to pay the debt in order to retain ownership of the property, to build her equity in the property, and to enjoy any future

taxpayer would have a large potential tax loss despite the fact that the taxpayer actually realized an economic gain in the like-kind exchange.

⁹² See sources cited *supra* notes 90-91. In *Brons Hotels*, it is unclear whether the debt involved was recourse or nonrecourse. According to the Stipulation of Facts, the taxpayer originally acquired the exchanged property subject to a mortgage of \$200,000, "the payment of which . . . was assumed by the [taxpayer]." *Brons Hotels*, 34 B.T.A. at 376.

⁹³ See WILLIAM A. KLEIN ET AL., *FEDERAL INCOME TAXATION* 238 (8th ed. 1990).

⁹⁴ See *id.*

⁹⁵ See *Crane v. Commissioner*, 331 U.S. 1, 13-14 (1947).

⁹⁶ *Id.* at 14.

appreciation of the property. Thus, the Supreme Court concluded that the term "money" in section 1001(b) includes nonrecourse debt relief as well as recourse debt relief.⁹⁷

In footnote 37 of the *Crane* decision, however, the Supreme Court observed that a taxpayer who owns property subject to nonrecourse debt that exceeds the value of the property cannot realize a benefit equal to the debt.⁹⁸ Although the Court did not expound further on this observation, the implication is clear. If the taxpayer sells such property, she will not likely receive any monetary consideration because the secured debt exceeds the value of the property. In addition, to retain ownership or to build equity in the property, the taxpayer must satisfy a debt that exceeds the value of the property. Thus, such a taxpayer has no economic incentive to pay the debt or to treat the debt as a personal debt. Having posed the footnote 37 question, the Supreme Court offered no further comment on whether that scenario would have made a difference in its holding.⁹⁹

Footnote 37 of the *Crane* decision went beyond mere dicta because it challenged any application of the main holding to a situation in which nonrecourse debt exceeds the property's fair market value ("footnote 37 fact pattern"). Subsequent courts that encountered footnote 37 fact patterns found that including nonrecourse debt relief in the amount realized only to the extent of the property's fair market value creates a different type of absurdity.¹⁰⁰ The absurdity is allowing the taxpayer to take the double deductions discussed above when the taxpayer suffered no economic loss.¹⁰¹

Notwithstanding the potentially absurd and inequitable results of allowing the taxpayer double deductions, footnote 37 appeared to suggest limiting the amount of nonrecourse debt relief includible in the amount realized to the fair market value of the property transferred.¹⁰² As a result, subsequent courts faced

⁹⁷ See *id.* at 13-14.

⁹⁸ *Id.* at 14 n.37.

⁹⁹ See *id.*

¹⁰⁰ See, e.g., *Millar v. Commissioner*, 577 F.2d 212, 215 (3d Cir.), *cert. denied*, 439 U.S. 1046 (1978).

¹⁰¹ See *id.*

¹⁰² *Crane*, 331 U.S. at 14 n.37. If the fair market value of the property equals the nonrecourse debt, the taxpayer has an economic incentive to pay the debt because she would receive property of equivalent value for the payment.

the possibility of accepting that limitation and its potentially absurd results. Instead, the courts adopted an alternative rationale for the *Crane* decision.¹⁰³ The courts adopted the double deduction rationale, which reflected “the spirit and reasoning of *Crane*”¹⁰⁴ in that it justified including the full amount of nonrecourse debt in the amount realized.

C. *The Parker Case*

*Parker v. Delaney*¹⁰⁵ was the first case after *Crane* that addressed a double deduction scenario. The taxpayer in *Parker* transferred property secured by acquisition nonrecourse debt to the mortgagee in satisfaction of the debt.¹⁰⁶ The outstanding balance of the debt equaled the property’s fair market value, but exceeded the taxpayer’s adjusted basis in the property.¹⁰⁷ The taxpayer’s adjusted basis reflected several years of depreciation deductions.¹⁰⁸

Parker raised the *Crane* question of whether the taxpayer should treat the nonrecourse debt relief as the receipt of money for purposes of computing the amount realized on the disposition of the mortgaged property.¹⁰⁹ Although the mortgaged property’s fair market value equaled the outstanding balance of the nonrecourse debt, the taxpayer contended that nonrecourse debt relief should not be treated as the receipt of money.¹¹⁰

The First Circuit rejected this argument, premising its holding on the *Crane* decision.¹¹¹ The court reasoned that as in *Crane*, the taxpayer in *Parker* received an economic benefit in the form of nonrecourse debt relief.¹¹² The taxpayer in *Crane* received an economic benefit because the fair market value of the property exceeded the amount of the nonrecourse debt.¹¹³ The taxpayer thus received cash in addition to the nonrecourse debt relief. In

¹⁰³ *Millar*, 577 F.2d at 215; *Tufts v. Commissioner*, 70 T.C. 756, 765 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. Unit A July 1981), *rev'd*, 461 U.S. 300 (1983).

¹⁰⁴ *Millar*, 577 F.2d at 215; *Tufts*, 70 T.C. at 765.

¹⁰⁵ 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951).

¹⁰⁶ *Id.* at 456-57.

¹⁰⁷ *Id.*

¹⁰⁸ *Id.* at 457-58.

¹⁰⁹ *Id.* at 458.

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ *Id.*

Parker, however, because the fair market value of the property equaled the outstanding balance of the nonrecourse debt, the taxpayer received no cash consideration in addition to the nonrecourse debt relief. The court decided that the additional monetary consideration absent in *Parker* but present in *Crane* was irrelevant. The court reasoned that the cash that the taxpayer in *Crane* received was important only because it showed that the value of the property at least equaled the amount of the nonrecourse debt.¹¹⁴

The First Circuit also determined that the taxpayer's depreciation deductions in *Parker* were based on the value of the mortgaged property.¹¹⁵ Because the nonrecourse debt was treated as a cost of the property and thus was included in the property's original basis, the taxpayer was allowed to take depreciation deductions with respect to the debt.¹¹⁶ The court therefore concluded that the amount realized on the disposition of the property must also account for the debt.¹¹⁷

The *Parker* case did not involve the typical double deduction scenario because the fair market value of the property equaled the outstanding balance of the nonrecourse debt when the taxpayer disposed of the secured property. Nonetheless, *Parker* was the first significant post-*Crane* decision. Footnote 37 of the *Crane* decision had left open the question of whether a taxpayer received an economic benefit by being relieved of a nonrecourse debt that exceeded the fair market value of the property encumbered by the debt.¹¹⁸ The *Parker* case did not require the First Circuit to answer this question because the outstanding balance of the debt did not exceed the fair market value of the mortgaged property.¹¹⁹ *Parker* did, however, extend the scope of the Supreme Court's holding in the *Crane* decision to any situation in which the fair market value of the secured property at least equals the outstanding balance of the nonrecourse debt.

D. It's Millar Time

Some thirty-one years after *Crane*, the Third Circuit addressed

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ See *Crane v. Commissioner*, 331 U.S. 1, 14 n.37 (1947).

¹¹⁹ *Parker*, 186 F.2d at 458.

the footnote 37 question in *Millar v. Commissioner*.¹²⁰ *Millar* involved taxpayers who were shareholders in a Subchapter S corporation (“S corporation”). The taxpayers incurred a nonrecourse loan secured by their stock in the S corporation.¹²¹ The taxpayers contributed the loan proceeds to the S corporation, thereby increasing the taxpayers’ basis in their stock.¹²² This stock basis increase allowed the taxpayers to take large flow-through deductions from the corporation.¹²³ Several years later, the lender foreclosed on the taxpayers’ stock.¹²⁴ At the time of foreclosure, the outstanding balance of the nonrecourse debt far exceeded both the stock’s fair market value and the taxpayers’ adjusted basis in the stock.¹²⁵

The Government treated the foreclosure as a disposition of the stock by the taxpayers governed by section 1001 of the Code.¹²⁶ The taxpayers, citing footnote 37 of the *Crane* decision, argued that their amount realized on the foreclosure included only the fair market value of the stock.¹²⁷ The Third Circuit rejected this argument. The court decided that the object of the *Crane* holding was to prevent taxpayers from taking double deductions.¹²⁸ The court explained that footnote 37 was dicta and at most posed a situation that was not then before the *Crane* Court.¹²⁹ In essence, the Third Circuit refused to interpret footnote 37 in a way inconsistent with the double deduction rationale of the *Crane* decision.¹³⁰

The *Millar* court clearly recast the *Crane* decision’s rationale as a pure tax benefit rationale. In *Millar*, double deductions would have occurred if the taxpayers’ basis had included the borrowed funds contributed to the S corporation, and the amount realized upon foreclosure had not included the debt’s outstanding balance. The initial inclusion of the proceeds of the nonrecourse

¹²⁰ 577 F.2d 212, 215 (3d Cir.), cert. denied, 439 U.S. 1046 (1978).

¹²¹ *Id.* at 213.

¹²² *Id.* at 215 (citing I.R.C. § 1016).

¹²³ *Id.* Under the Code, a shareholder of an S corporation is allocated a pro rata share of the corporation’s losses and deductions. See I.R.C. § 1366(a)(1)(A).

¹²⁴ *Millar*, 577 F.2d at 213.

¹²⁵ *Id.* at 214-15.

¹²⁶ See *id.* at 213-14.

¹²⁷ *Id.* at 214.

¹²⁸ *Id.* at 215.

¹²⁹ *Id.*

¹³⁰ *Id.* at 215-16.

debt in the taxpayers' basis would have allowed flow-through deductions to the taxpayers from the S corporation.¹³¹ Then, limiting the amount realized to the property's fair market value would have reduced the taxpayers' gain by the economic depreciation of the stock. This would have given the taxpayers, in effect, a second set of deductions.

The court determined that allowing the taxpayers initial flow-through deductions from the S corporation and then a subsequent deductible loss on the disposition of their stock was not justified.¹³² Allowing the taxpayers to take those deductions presupposed that the taxpayers contributed their own money to the S corporation, which, in turn, lost the money. Then, because the S corporation was unable to repay the money, the taxpayers suffered the economic loss. In reality, the taxpayers lost nothing because the money that the S corporation lost consisted of funds borrowed by the taxpayers that the taxpayers never repaid. Rather, the lender suffered the economic loss because the lender took back stock worth less than the outstanding balance of the loan.¹³³

After the *Millar* decision, the Tax Court adopted the Third Circuit's double deduction rationale.¹³⁴ In *Commissioner v. Tufts*,¹³⁵ however, the Supreme Court rejected the double deduction rationale in favor of the loan proceeds rationale.¹³⁶

III. THE LOAN PROCEEDS RATIONALE AND THE LOAN PROCEEDS SCENARIO CASES

A. *Origin of the Loan Proceeds Rationale*

The loan proceeds scenario cases involve taxpayers who obtain nonrecourse loans by pledging pre-owned property. The taxpayers use the loan proceeds for purposes other than acquiring or improving the pledged property. Thus, the property's basis does not include the loan proceeds. Before the Supreme Court's *Tufts* decision, the loan proceeds scenario cases were the only cases in which the courts applied the loan proceeds rationale.

¹³¹ *Id.* at 215.

¹³² *Id.*

¹³³ *Id.* at 214.

¹³⁴ See *Tufts v. Commissioner*, 70 T.C. 756, 765-66 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. Unit A July 1981), *rev'd*, 461 U.S. 300 (1983).

¹³⁵ 461 U.S. 300 (1983).

¹³⁶ *Id.* at 307-10.

Ironically, the loan proceeds scenario cases are similar to the double deduction scenario cases. Both involve the discharge of secured nonrecourse debt that exceeds the fair market value of the secured property, pursuant to the property's transfer. The only difference between the two types of cases is that the double deduction scenario cases involve acquisition debt, while the loan proceeds scenario cases involve nonacquisition debt. As in the double deduction scenario cases, the courts treat the transfer of the property to the lender in full satisfaction of the debt as a disposition of property governed by section 1001 of the Code.¹³⁷ In contrast to the double deduction scenario cases, the courts apply the loan proceeds rationale to hold that the amount realized includes the full amount of the nonrecourse debt.¹³⁸

The loan proceeds rationale involves a two-step analysis. First, when a taxpayer borrows funds secured by pre-owned property, the taxpayer receives the proceeds to use free from restriction.¹³⁹ The taxpayer does not, however, realize gross income because the economic benefit received is offset by the simultaneous obligation to repay the amount borrowed.¹⁴⁰ Second, in lieu of repaying the loan, the taxpayer transfers the secured property to the creditor in full satisfaction of the debt.¹⁴¹ It is as if the creditor purchased the secured property from the taxpayer by allowing the taxpayer to retain the amount of the forgiven loan.

At this point, the taxpayer realizes gross income because the economic benefit of the borrowed funds is no longer offset by a simultaneous obligation to repay the amount borrowed.¹⁴² The courts treat the transfer as a disposition of property governed by section 1001 of the Code.¹⁴³ Gross income results to the extent that the amount realized (in this case, the amount of the forgiven debt) exceeds the taxpayer's adjusted basis in the transferred property.¹⁴⁴

¹³⁷ *Woodsam Assocs., Inc. v. Commissioner*, 16 T.C. 649, 655 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952); *Lutz & Schramm Co. v. Commissioner*, 1 T.C. 682, 688 (1943).

¹³⁸ See *Woodsam Assocs.*, 16 T.C. at 653-54; *Lutz & Schramm*, 1 T.C. at 689.

¹³⁹ See, e.g., *Mendham Corp. v. Commissioner*, 9 T.C. 320, 323 (1947).

¹⁴⁰ See *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983); *Mendham Corp.*, 9 T.C. at 323.

¹⁴¹ See, e.g., *Mendham Corp.*, 9 T.C. at 322-23.

¹⁴² See, e.g., *id.* at 323.

¹⁴³ See I.R.C. § 1001; *supra* notes 75 and 87 (providing text of § 1001(a)-(b)); *Mendham Corp.*, 9 T.C. at 323.

¹⁴⁴ See *Mendham Corp.*, 9 T.C. at 323.

B. The Loan Proceeds Scenario Cases

*Lutz & Schramm Co. v. Commissioner*¹⁴⁵ is a typical loan proceeds scenario case. In *Lutz & Schramm*, a taxpayer acquired real property in 1924.¹⁴⁶ One year later, the taxpayer conveyed a mortgage on the property to a creditor to whom the taxpayer owed \$361,000.¹⁴⁷ In 1934, as part of an effort to work out its financial problems, the taxpayer reduced the debt to \$300,000.¹⁴⁸ In turn, the creditor agreed to convert the debt to a nonrecourse liability debt secured only by the property.¹⁴⁹ Finally, in 1937, the taxpayer transferred the property to the creditor in full satisfaction of the nonrecourse debt. At the time of transfer, the outstanding balance of the nonrecourse debt remained \$300,000, and the fair market value of the property was \$97,000.¹⁵⁰

The issue in the case was the tax consequences of the taxpayer's transfer of the secured property to the creditor. Initially, the court determined that the transfer was a disposition of property governed by the predecessor of section 1001 of the Code.¹⁵¹ The court then focused on determining the amount realized on the disposition of the property for purposes of computing gain on the transaction.¹⁵²

The court relied on the loan proceeds rationale to make this determination.¹⁵³ The court noted that the taxpayer had enjoyed the benefit of the borrowed money since 1924.¹⁵⁴ The court then observed that the creditor had later discharged the taxpayer's obligation to repay the debt in exchange for the taxpayer's transfer of the secured property to the creditor, even though the secured property was worth less than the debt.¹⁵⁵ The court reasoned that extinguishing the taxpayer's obligation to repay the debt would defeat the reason for allowing the taxpayer to receive loan proceeds without realizing gross income.¹⁵⁶ Thus, the court

¹⁴⁵ 1 T.C. 682 (1943).

¹⁴⁶ *Id.* at 684.

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 684-85.

¹⁵¹ *Id.* at 688.

¹⁵² *Id.* at 688-89.

¹⁵³ See *infra* notes 154-58 and accompanying text.

¹⁵⁴ *Lutz & Schramm*, 1 T.C. at 688.

¹⁵⁵ *Id.* at 689.

¹⁵⁶ *Id.*

required the taxpayer to include the loan proceeds in the amount realized upon transfer of the secured property to the creditor.¹⁵⁷ As a result, the taxpayer realized and recognized taxable income to the extent that the amount of the forgiven debt exceeded the taxpayer's adjusted basis in the secured property.¹⁵⁸

Two later cases, *Mendham Corp. v. Commissioner*¹⁵⁹ and *Woodsam Associates, Inc. v. Commissioner*,¹⁶⁰ were decided on grounds similar to *Lutz & Schramm*. In each case, the taxpayer had acquired property in a tax-free exchange.¹⁶¹ The property was subject to a liability incurred by the person from whom the taxpayer acquired the property.¹⁶² The liability was secured by the property, but the liability was nonrecourse with respect to the taxpayer.¹⁶³ Eventually, the creditor foreclosed on the property. At that time, the debt's outstanding balance exceeded the property's fair market value.¹⁶⁴

In both cases, the Tax Court held that the taxpayer realized gain on the foreclosed property, as measured by the difference between the outstanding nonrecourse liability and the property's adjusted basis.¹⁶⁵ Although the taxpayer was not the original borrower of the released debt, the Tax Court attributed the benefit of the borrowed money to the taxpayer because the taxpayer was the successor owner of the property pursuant to a tax-free exchange with the original borrower.¹⁶⁶ The court then concluded that it was proper to tax the taxpayer for this gain, applying the loan proceeds rationale as if the taxpayer had been the original borrower.¹⁶⁷

IV. DEFICIENCIES OF THE *KIRBY LUMBER* DOCTRINE AND THE DOUBLE DEDUCTION RATIONALE

Of the three tests for determining whether a taxpayer recognizes gross income from the discharge of debt, the *Kirby Lumber*

¹⁵⁷ *Id.* at 688-89.

¹⁵⁸ *Id.*

¹⁵⁹ 9 T.C. 320 (1947).

¹⁶⁰ 16 T.C. 649 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952).

¹⁶¹ *Woodsam Assocs.*, 16 T.C. at 650-52; *Mendham Corp.*, 9 T.C. at 321.

¹⁶² *Woodsam Assocs.*, 16 T.C. at 651; *Mendham Corp.*, 9 T.C. at 321.

¹⁶³ *Woodsam Assocs.*, 16 T.C. at 650; *Mendham Corp.*, 9 T.C. at 321.

¹⁶⁴ *Woodsam Assocs.*, 16 T.C. at 654; *Mendham Corp.*, 9 T.C. at 322-23.

¹⁶⁵ *Woodsam Assocs.*, 16 T.C. at 653, 655; *Mendham Corp.*, 9 T.C. at 323-25.

¹⁶⁶ *Woodsam Assocs.*, 16 T.C. at 655-56; *Mendham Corp.*, 9 T.C. at 324-25.

¹⁶⁷ *Woodsam Assocs.*, 16 T.C. at 655-56; *Mendham Corp.*, 9 T.C. at 324-25.

doctrine and the double deduction rationale are deficient because, under certain circumstances, they lead to absurd results. Only the loan proceeds rationale reaches the appropriate result in every discharge of debt scenario.

A. *Deficiencies of the Kirby Lumber Doctrine*

The *Kirby Lumber* doctrine is deficient because it focuses upon the immediate consequences of the discharge instead of upon the taxpayer's prior tax-free use of the borrowed funds.¹⁶⁸ The *Kirby Lumber* doctrine finds DOI when the discharge of a debt increases a debtor's net worth by freeing assets otherwise required to satisfy the forgiven debt. Assets can be freed only if the discharge of debt creates or increases the debtor's positive net worth.¹⁶⁹ To the extent that the debtor's net worth remains negative after a discharge of debt, however, none of the debtor's assets are freed. In this situation, the courts have limited application of the *Kirby Lumber* doctrine, holding that a debtor who continues to have a negative net worth after a discharge of debt (the "insolvency scenario") does not realize DOI.¹⁷⁰

This is an incorrect result. The *Kirby Lumber* doctrine misses the mark in the insolvency scenario because the debtor has actually realized an accession to wealth that should not escape taxation.¹⁷¹ Application of the loan proceeds rationale to the insolvency scenario reveals how an insolvent debtor who remains insolvent after a discharge of debt can realize an accession to wealth.

Under the loan proceeds rationale, a taxpayer is not taxed on the receipt of borrowed money because the economic benefit she receives is offset by her simultaneous obligation to repay the amount borrowed.¹⁷² Accordingly, she enjoys the tax-free economic benefit of the loan proceeds during the time the loan is outstanding. If the lender later forgives all or part of the loan, the economic benefit is no longer offset by the taxpayer's obligation to repay the forgiven debt.

¹⁶⁸ See *supra* notes 50-53 and accompanying text.

¹⁶⁹ See *supra* notes 54-69 and accompanying text.

¹⁷⁰ Estate of Newman v. Commissioner, 934 F.2d 426, 426 (2d Cir. 1991); Madison Rys. v. Commissioner, 36 B.T.A. 1106, 1108 (1937); Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289, 291 (1937).

¹⁷¹ See *infra* notes 172-74 and accompanying text.

¹⁷² See, e.g., United States v. Rochelle, 384 F.2d 748 (5th Cir. 1967), *cert. denied*, 390 U.S. 946 (1968).

This defeats the reason for allowing the taxpayer to receive the borrowed funds without recognizing gross income. To ameliorate this situation, the loan proceeds rationale provides that the event of discharge establishes as an accession to wealth the taxpayer's prior receipt of the loan proceeds. Accordingly, the event of discharge is the proper time to require the taxpayer to include in gross income the amount of the forgiven debt.

By failing to find DOI in the insolvency scenario, the courts make the taxpayer's insolvency a condition of taxation. If the courts condition DOI on the debtor's solvency, why not condition all other incidents of taxation on the taxpayer's solvency?¹⁷³ The *Kirby Lumber* doctrine's failure to find DOI in the insolvency scenario thus leads to the absurd and inequitable result of giving insolvent debtors a tax-free or tax-preferred benefit when they have in fact realized an accession to wealth.¹⁷⁴

B. Deficiencies of the Double Deduction Rationale

1. Depreciation Deductions Are Not the Value the Taxpayer Receives from Borrowing

One reason that the double deduction rationale is deficient is that it mistakenly focuses on preventing the taxpayer from taking

¹⁷³ See *Estate of Newman*, 934 F.2d at 430-31 (tracing history of insolvency exception doctrine). In *Estate of Newman*, the Second Circuit commented on the absurdity of the insolvency exception to the *Kirby Lumber* doctrine as follows:

The logic of the insolvency exception is not obvious. Cash income to an insolvent debtor is taxable even if the debtor remains insolvent and the cash is used solely to discharge part of the debt. Moreover, the discharge of a debt for less than its face amount is taxable income to the debtor because the borrowed funds were excluded from debtor's gross income when first received.

Id.

¹⁷⁴ In *Estate of Newman*, the Second Circuit further commented:

As noted above, cash income to an insolvent debtor is taxable even though the debtor remains insolvent after using the cash to reduce the burden of debt and even though assets are no more freed in that case than in the case of forgiveness of a portion of an insolvent debtor's debt. As also noted above, the proceeds from borrowed funds are excluded from gross income when received because they are offset by the obligation to repay. If the taxpayer is relieved from the obligation, there is no longer a basis for the original exclusion.

Id. at 432.

unwarranted deductions. The depreciation deductions allowed to the taxpayer in the double deduction scenario cases provide her an economic benefit by enabling her to offset other income and thus pay less tax. However, these deductions are not the reason that the taxpayer realizes an accession to wealth. Rather, the taxpayer's accession to wealth stems from the value of the property that the taxpayer receives from borrowing.

In the double deduction scenario cases, during the time that the taxpayer owns the property subject to the acquisition debt, she enjoys the economic benefits of property ownership tax-free because of a simultaneous obligation to repay the debt.¹⁷⁵ One of these economic benefits is the ability to take depreciation deductions to offset other income.¹⁷⁶ These depreciation deductions are not, however, the value that the taxpayer receives from borrowing. Instead, the value is the depreciable property acquired with the acquisition debt. The taxpayer uses this property to carry out her trade or business, or to produce income.¹⁷⁷ Our tax system allows the taxpayer depreciation deductions with respect to such property to compensate her for the fact that over time, the property will wear out and no longer serve its intended function.¹⁷⁸

Thus, the correct focus in the double deduction scenario cases should not be on preventing double deductions, but on requiring the taxpayer to include in the amount realized for purposes of computing gross income the borrowed value received in the form of property acquired with nonrecourse debt.¹⁷⁹ The taxpayer's

¹⁷⁵ See *supra* note 172 and accompanying text. The Supreme Court has articulated some of the economic benefits that a property owner receives as follows: "In his opinion for the Court of Appeals in *Crane*, Judge Learned Hand observed: '[The mortgagor] has all the income from the property; he manages it; he may sell it; any increase in value goes to him; any decrease falls on him'" *Commissioner v. Tufts*, 461 U.S. 300, 312 n.12 (1983).

¹⁷⁶ Depreciation deductions are allowed pursuant to §§ 167 and 168 of the Code. See I.R.C. §§ 167-168. Under § 167(c) of the Code, the depreciable basis of property is the property's adjusted basis as defined in § 1011 of the Code. I.R.C. § 167(c). Section 1011 of the Code defines adjusted basis as the cost of the property as adjusted under § 1016 of the Code. I.R.C. § 1011. Pursuant to the *Crane* doctrine, the cost of property includes nonrecourse acquisition debt. *Crane v. Commissioner*, 331 U.S. 1, 14 (1947).

¹⁷⁷ See I.R.C. § 167(a)(1)-(2).

¹⁷⁸ See I.R.C. §§ 167-168.

¹⁷⁹ See I.R.C. §§ 1001(a) (setting forth formula for computing gain or

transfer of the acquired property in satisfaction of the debt establishes that the taxpayer will never pay for the value received beyond transferring the secured property to the lender. Therefore, it is appropriate to require the taxpayer to include the debt relief in the amount realized for purposes of computing gain on the transaction.

2. Double Deduction Rationale Should Not Apply to Non-Depreciable Property

Another reason that the double deduction rationale is deficient is that by its description, it should only apply so as to prevent the taxpayer from taking two sets of unwarranted deductions. Thus, the double deduction rationale should not find gross income if the secured property is non-depreciable. Absent depreciation deductions on non-depreciable property, the taxpayer will not be able to take the first of the two sets of unwarranted deductions. Therefore, if the taxpayer cannot take double deductions, there is no reason to apply the double deduction rationale.¹⁸⁰

The foregoing illustration of the double deduction rationale's failure to find gross income presents another example of the rationale's deficiency. As stated above, the correct focus in the double deduction scenario cases should not be on preventing double deductions, but on requiring the taxpayer to include in the amount realized for purposes of computing gross income the borrowed value received in the form of property acquired with nonrecourse debt.

3. Footnote 37 of the *Crane* Decision Misstates the Issue in the Double Deduction Scenario Cases

In footnote 37 of the *Crane* decision, the Supreme Court

loss), 61(a)(3) (defining gross income as including gains derived from property).

¹⁸⁰ In a double deduction scenario involving non-depreciable land, a taxpayer would not be allowed to take depreciation deductions with respect to the secured property. In that case, if the amount realized were limited to the fair market value of the secured property, she would, however, be able to reduce her gain or create a loss by the economic depreciation of the land for which she suffered no actual loss. As a result, the taxpayer would receive one set of unwarranted deductions. It would appear that a rationale based upon preventing the taxpayer from taking unwarranted deductions should not permit even a single unwarranted deduction. I am not aware of any case addressing this scenario.

observed that a taxpayer who owns property subject to nonrecourse debt that exceeds the value of the property cannot realize a benefit equal to the debt.¹⁸¹ Footnote 37 raised a question not before the Court in that the fair market value of the secured property in *Crane* exceeded the nonrecourse debt.¹⁸² As a result, the taxpayer received monetary consideration in addition to the debt relief. Under those circumstances, the Court reasoned that it did not matter whether the debt was recourse or nonrecourse. In either case, it was as if the taxpayer had received the full consideration in cash, paid off the debt, and kept the rest of the cash for herself.¹⁸³

The *Crane* holding should not apply to a footnote 37 fact pattern because nonrecourse debt relief is not the economic equivalent of recourse debt relief in that situation. This is because no economic benefits flow to the taxpayer from the discharge of the nonrecourse debt.¹⁸⁴ For example, the taxpayer will not likely receive any monetary consideration as a result of the discharge. In addition, because the taxpayer's liability is limited to the value of the secured property, she will receive no economic benefit to the extent that the nonrecourse liability in excess of the property's fair market value is released. Accordingly, footnote 37 suggests that in a footnote 37 fact pattern, the taxpayer's amount realized cannot exceed the fair market value of the property.¹⁸⁵

Similar to the *Kirby Lumber* doctrine, footnote 37 misstates the

¹⁸¹ *Crane v. Commissioner*, 331 U.S. 1, 14 n.37 (1947).

¹⁸² *See id.*

¹⁸³ *Id.*

¹⁸⁴ In response to the footnote 37 question, subsequent courts have ignored the portion of the Court's holding discussing the economic equivalence of nonrecourse debt and recourse debt. Instead, these courts developed the double deduction rationale to justify including the full amount of the debt in the amount realized in a footnote 37 fact pattern. *See supra* notes 103-36 and accompanying text (discussing application of double deduction rationale to footnote 37 fact pattern).

¹⁸⁵ Because a taxpayer will not receive monetary consideration unless the fair market value exceeds the outstanding nonrecourse debt, an argument can be made that footnote 37 suggests that nonrecourse debt should be included in the amount realized only in that situation. A contrary argument can be made that if the fair market value of the property equals the nonrecourse debt, the taxpayer has an economic incentive to pay the debt because by paying the debt the taxpayer would receive equivalent value. This would justify treating nonrecourse debt like recourse debt and including the outstanding balance in the amount realized on the disposition

issue because it focuses only on the immediate consequences of the debt release instead of on the taxpayer's prior tax-free use of the property acquired with the nonrecourse debt. In a footnote 37 fact pattern, the issue is not what the taxpayer receives from the transfer of the property, but how the transfer affects what the taxpayer has already received. The taxpayer has already received the tax-free economic benefits of ownership of the secured property. The tax-free treatment of such benefits is conditioned upon her simultaneous obligation to repay the debt. When she transfers the secured property in full satisfaction of the debt, the transfer extinguishes her obligation to repay the debt. Therefore, it is appropriate to recharacterize the prior tax-free receipt as taxable by requiring the taxpayer to include the debt relief in the amount realized on the disposition of the property.

4. Similarity of Double Deduction Scenario Cases and Loan Proceeds Scenario Cases Dictates Application of Loan Proceeds Rationale in Both

The loan proceeds scenario cases and the double deduction scenario cases were decided around the same time and involved, in substance, identical discharge of debt scenarios. It is therefore difficult to understand why, prior to the Supreme Court's *Tufts* decision, the courts did not apply the loan proceeds rationale to double deduction scenario cases. The courts should apply the loan proceeds rationale to double deduction scenario cases for two reasons. First, the double deduction scenario and the loan proceeds scenario are basically identical. Second, the loan proceeds rationale finds gross income in every double deduction scenario in which the taxpayer realizes an accession to wealth.

a. The First Step of the Loan Proceeds Rationale—Tax-Free Use of the Secured Property

Under the first step of the loan proceeds rationale, gross income does not result in a loan proceeds scenario case because the economic benefit of the loan proceeds is offset by a simultaneous obligation to repay the amount borrowed.¹⁸⁶ The only differ-

of the underlying property. *Cf. Odend'hal v. Commissioner*, 748 F.2d 908, 912-13 (4th Cir. 1984), *cert. denied*, 471 U.S. 1143 (1985).

¹⁸⁶ *Woodsam Assocs., Inc. v. Commissioner*, 16 T.C. 649, 655 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952); *Lutz & Schramm Co. v. Commissioner*, 1 T.C. 682, 688 (1943).

ence between the double deduction scenario cases and the loan proceeds scenario cases is the form of the value received from borrowing. In the loan proceeds scenario cases, the taxpayer receives value in the form of money from borrowing; in the double deduction scenario cases, the taxpayer receives value in the form of property from borrowing.

Although the taxpayer receives different forms of value, the substance of the borrowings is identical. Acquiring value in the form of property with acquisition debt is the same as receiving the equivalent value in the form of money, and then using that money to purchase the property.¹⁸⁷ During the time that the taxpayer owns the property subject to the acquisition debt, she enjoys the economic benefits of ownership of the property tax-free, just as she would enjoy the use of borrowed money tax-free. In both scenarios, the value that the taxpayer receives from borrowing is not included in gross income because of her simultaneous obligation to repay the debt. Thus, the taxpayer's tax-free use of the secured property in the double deduction scenario cases tracks the first step of the loan proceeds rationale.

b. The Second Step of the Loan Proceeds Rationale—Relief of the Acquisition Debt Establishes Prior Receipt of the Secured Property as an Accession to Wealth

Under the second step of the loan proceeds rationale, a subsequent transfer of the secured property in full satisfaction of the debt in a loan proceeds scenario case releases the taxpayer of any further obligation to repay the debt. It is as if the creditor purchased the secured property from the taxpayer by allowing the taxpayer to retain the amount of the forgiven debt. The taxpayer realizes income because the economic benefit of the borrowed funds is no longer offset by a simultaneous obligation to repay the amount loaned.¹⁸⁸ Gross income results to the extent that the amount realized (in this case, the amount of the forgiven debt) exceeds the taxpayer's adjusted basis in the secured property.¹⁸⁹

The second step of the loan proceeds rationale also applies to the double deduction scenario cases. The only difference between the loan proceeds scenario cases and the double deduc-

¹⁸⁷ *Cf.* Commissioner v. Tufts, 461 U.S. 300, 307 (1983) (stating that loan proceeds do not qualify as income to taxpayer).

¹⁸⁸ *Id.* at 308-10.

¹⁸⁹ Mendham Corp. v. Commissioner, 9 T.C. 320, 322-23 (1947).

tion scenario cases is the underlying circumstances of the transfer of the secured property to the mortgagee. In the loan proceeds scenario cases, the transfer of the pre-owned property was in satisfaction of a nonrecourse monetary loan. In the double deduction scenario cases, the transfer of the secured property was in satisfaction of the acquisition nonrecourse borrowing used to acquire the property.¹⁹⁰

Arguably, the loan proceeds scenario cases and the double deduction scenario cases can be distinguished by asserting that in the double deduction scenario cases, the taxpayer's transfer of the secured property was in effect the repayment of exactly what the taxpayer borrowed. Thus, one can argue that the courts should not apply the loan proceeds rationale to double deduction scenario cases. The distinction between the two types of cases, however, does not support this argument.

Under the first step of the loan proceeds rationale, the significance of borrowing is not the form that it takes, but the value received from it. This is because to totally satisfy the loan, the taxpayer must repay the value of the property at the time of borrowing. Thus, gross income does not result whether the form of value received from borrowing is money or property, because the economic benefits of borrowing are offset by the taxpayer's simultaneous obligation to repay the value borrowed.

Under the second step of the loan proceeds rationale, the debt is totally satisfied not by repaying the value borrowed in money, but by transferring the secured property to the lender. This defeats the reason for not including the value of borrowing in gross income. Because the transfer is treated as a disposition of property pursuant to section 1001 of the Code, gain must be computed by subtracting the taxpayer's adjusted basis in the secured property from the amount realized.¹⁹¹ The taxpayer's amount realized is the value of borrowing that the taxpayer will never have to repay beyond transferring the secured property to the lender. Therefore, it is irrelevant that the property transferred to the lender is in form repayment of exactly what the taxpayer borrowed. The taxpayer realizes gross income to the

¹⁹⁰ *But see* Millar v. Commissioner, 577 F.2d 212 (3d Cir.) (analyzing scenario in which loan proceeds used not to acquire property, but to make capital contribution to Subchapter S corporation owned by taxpayers), *cert. denied*, 439 U.S. 1046 (1978).

¹⁹¹ *See* I.R.C. § 1001(a); *supra* note 75 (providing text of § 1001(a)).

extent that the debt relief exceeds her adjusted basis in the transferred property.¹⁹²

This result is analogous to the results in a number of cases involving the transfer of stock to satisfy a monetary claim that was treated as a taxable disposition of property under section 1001(a) of the Code.¹⁹³ The courts in these cases held that the taxpayer's amount realized was "money's worth" in the amount of the discharged claim.¹⁹⁴ The taxpayer thus realized gain to the extent that the amount of the monetary claim exceeded the taxpayer's adjusted basis in the stock transferred to the claim holder.¹⁹⁵ The same reasoning suggests that it is appropriate to require the taxpayer in a double deduction scenario case to account for the prior receipt of the economic benefits of ownership by including the debt relief in the amount realized upon transfer of the secured property.

V. TUFTS ELIMINATES THE DOUBLE DEDUCTION RATIONALE

At stake in the Supreme Court's *Tufts* decision was whether the Court would accept the double deduction rationale as the answer to the question that footnote 37 of the *Crane* decision had posed.¹⁹⁶ The Tax Court in *Tufts* had applied the *Millar* decision's double deduction rationale, holding that the amount realized included the entire balance of the nonrecourse debt.¹⁹⁷ On appeal, the Fifth Circuit reversed the Tax Court.¹⁹⁸ When the Supreme Court eventually accepted the case for review, it replaced the double deduction rationale with the loan proceeds rationale. However, the Court did not directly address the validity of the double deduction rationale.¹⁹⁹

In *Tufts*, a partnership borrowed about \$1,851,500 from a

¹⁹² See I.R.C. §§ 1001(a), 61(a)(3).

¹⁹³ See *International Freighting Corp. v. Commissioner*, 135 F.2d 310, 313 (2d Cir. 1943); *Commissioner v. Mesta*, 123 F.2d 986, 988 (3d Cir. 1941), *cert. denied*, 316 U.S. 695 (1942); *Kenan v. Commissioner*, 114 F.2d 217, 219-20 (2d Cir. 1940).

¹⁹⁴ See sources cited *supra* note 193.

¹⁹⁵ See sources cited *supra* note 192.

¹⁹⁶ See *Commissioner v. Tufts*, 461 U.S. 300, 302 (1983).

¹⁹⁷ *Tufts v. Commissioner*, 70 T.C. 756, 765-66 (1978), *rev'd*, 651 F.2d 1058 (5th Cir. Unit A July 1981), *rev'd*, 461 U.S. 300 (1983).

¹⁹⁸ *Tufts v. Commissioner*, 651 F.2d 1058 (5th Cir. Unit A July 1981), *rev'd*, 461 U.S. 300 (1983).

¹⁹⁹ See *Commissioner v. Tufts*, 461 U.S. 300, 310 (1983).

savings and loan association (the “lender”) in August 1970 to construct a 120-unit apartment complex.²⁰⁰ The partnership executed and conveyed a note and a deed of trust to the lender.²⁰¹ The loan was nonrecourse with respect to the partnership and its partners.²⁰²

The partners claimed sizable depreciation deductions from the property for the years 1971 and 1972.²⁰³ In August 1972, adverse economic conditions prevented the partnership from generating enough rental income from the complex to make principal payments on the debt.²⁰⁴ As a result, each partner conveyed his interest in the apartment complex to a third party purchaser. The partners also received nominal expense reimbursements related to the conveyance.²⁰⁵ At the time of the conveyance, the loan’s outstanding balance was \$1,851,500, the complex’s fair market value was \$1,400,000, and the complex’s adjusted basis was \$1,455,740.²⁰⁶

The case presented the footnote 37 issue of whether to limit the amount realized to the fair market value of the property.²⁰⁷ Consistent with the result in *Millar*, the Supreme Court held that the amount realized included the full amount of the nonrecourse debt.²⁰⁸ In reaching its decision, however, the Court departed from *Millar* by adopting the loan proceeds rationale instead of the double deduction rationale.²⁰⁹

In adopting the loan proceeds rationale, the Supreme Court reexamined the *Crane* decision. The Court explained that the limited theory of economic benefit was not the basis of *Crane*’s holding.²¹⁰ Instead, it characterized *Crane* as holding that

²⁰⁰ *Id.* at 302.

²⁰¹ *Id.*

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.* at 303.

²⁰⁵ *Id.*

²⁰⁶ *Id.* at 302-03.

²⁰⁷ *Id.*

²⁰⁸ *Id.* at 317.

²⁰⁹ *Id.* at 310. Unfortunately, the Court did not expressly reject the double deduction rationale; instead, it noted in footnote 10 that because the Court had resolved the issue on other grounds, it need not address the validity of the double deduction rationale. *Id.* at 310 n.10.

²¹⁰ *Id.* at 307. The economic benefit theory of the original *Crane* decision was that the word “money,” as used in § 1001(b) of the Code for purposes of determining the amount realized, included nonrecourse liability relief as

nonrecourse debt was like a "true loan."²¹¹ The Court explained that with respect to any loan, the receipt of loan proceeds is tax-free because the taxpayer must repay the loan at a future date.²¹² If the taxpayer chooses to use the proceeds to purchase an apartment complex, that transaction is also tax-free because the taxpayer must still repay the debt.²¹³ Moreover, the taxpayer is entitled to include the amount of the borrowed proceeds in the property's basis.²¹⁴

The taxpayer's later transfer of the property subject to the debt triggers a realization of income because the transfer releases the taxpayer from any further obligation to repay the debt.²¹⁵ As the Court noted, this obligation is the sole reason for allowing the taxpayer to not recognize gross income upon receipt of the loan proceeds.²¹⁶ The Court then concluded that if the transfer does not trigger a realization of income, the taxpayer will enjoy an unwarranted economic benefit to the extent that it receives funds upon which it will never have to pay tax.²¹⁷

VI. THE TAX COURT'S *ZARIN* OPINION NULLIFIES THE *KIRBY LUMBER* DOCTRINE

Similar to the Supreme Court's adoption of the loan proceeds rationale in *Tufts*, the Tax Court applied the loan proceeds rationale in *Zarin v. Commissioner*²¹⁸ to find DOI in a discharge of debt scenario in which the *Kirby Lumber* doctrine would not find DOI. In *Zarin*, the taxpayer, David Zarin ("Zarin"), gambled excessively at the crap tables of the Resorts International Hotel (the "Casino").²¹⁹ At the height of his gambling, Zarin often bet the maximum amount that the Casino allowed. Zarin's high stakes gambling created excitement at the tables and enticed other

if it were the economic equivalent of recourse liability relief. *See supra* notes 83-97 and accompanying text (discussing *Crane* decision).

²¹¹ *See Tufts*, 461 U.S. at 307.

²¹² *Id.*

²¹³ *See id.*

²¹⁴ *Id.*

²¹⁵ The realization of income occurs by including the amount of the debt relief in the amount realized on the disposition of the secured property.

²¹⁶ *Tufts*, 461 U.S. at 308-09.

²¹⁷ *Id.* at 310. The Court also noted that the effect of not requiring the taxpayer to realize the unpaid debt upon the disposition of the property would be an unwarranted increase in basis. *Id.*

²¹⁸ 92 T.C. 1084 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990).

²¹⁹ *Id.* at 1085-86.

Casino patrons to follow his example.²²⁰

Due to Zarin's positive influence on business, the Casino pampered him in an effort to encourage his continued presence at the tables. The Casino provided Zarin free hotel amenities and a liberal gambling line of credit.²²¹ As time went on, Zarin's line of credit soared from \$10,000 to \$200,000.²²² In addition, the Casino helped Zarin extend his line of credit beyond the limits permitted by New Jersey law.²²³ At one point, Zarin's gambling debt reached \$2.5 million, which he paid in full.²²⁴

By 1980, however, heavy losses left Zarin indebted to the Casino for \$3,435,000.²²⁵ At this point, the Casino suspended Zarin's line of credit and demanded payment in full. Zarin paid the Casino with personal checks that were later returned for insufficient funds.²²⁶ The Casino then sued Zarin in state court to recover the outstanding amount of the debt. A key issue in the state court action was whether Zarin's gambling debt was enforceable.²²⁷ Rather than litigate the case, Zarin settled his debt with the Casino for \$500,000.²²⁸

After the state court settlement, the Commissioner of the Internal Revenue Service (the "Commissioner") issued Zarin a Notice of Deficiency. The Commissioner asserted that the difference between the gambling debt of \$3.4 million and the \$500,000 settlement resulted in DOI of \$2.9 million.²²⁹ Zarin petitioned the Tax Court for a redetermination of this issue.

Because the issue involved DOI, the *Kirby Lumber* doctrine was a consideration.²³⁰ Zarin argued that, because the debt was unenforceable, the discharge could not generate DOI under the *Kirby Lumber* doctrine. He reasoned that the discharge of an unenforceable debt did not free any of his assets because the debt had never encumbered any of those assets.²³¹ Zarin presented a valid inter-

²²⁰ *Id.* at 1086.

²²¹ *Id.*

²²² *Id.*

²²³ *Id.* at 1087.

²²⁴ *Id.*

²²⁵ *Id.* at 1088.

²²⁶ *Id.*

²²⁷ *Id.* at 1090.

²²⁸ *Id.* at 1088.

²²⁹ *Id.* at 1085.

²³⁰ *Id.* at 1089.

²³¹ *Id.* at 1090.

pretation of the *Kirby Lumber* doctrine, in that the discharge of his unenforceable gambling debt failed to free any of his assets, and thus did not increase his net worth.

By a slim majority of eleven to eight, the Tax Court rejected this interpretation and held that Zarin realized DOI from the discharge of his gambling debt for less than the debt's outstanding balance.²³² The Tax Court, relying in large part on the Supreme Court's *Tufts* decision, applied the loan proceeds rationale to reach this result.²³³ The court found that when Zarin incurred the \$3.4 million debt, he received the benefit of a \$3.4 million monetary credit, or a loan to gamble.²³⁴ The Casino would have required any other patron to pay \$3.4 million for the same amount of chips. The gambling chips would have been taxable at the time of receipt but for Zarin's promise to repay the gambling loan.²³⁵ Thus, when the Casino later forgave a portion of the debt, the Commissioner properly required Zarin to account for this monetary benefit and to recognize as DOI the amount of the debt he would never have to repay.²³⁶

The Tax Court's *Zarin* opinion was the first reported decision in which a court applied the loan proceeds theory to find gross income in a discharge of debt scenario in which the *Kirby Lumber* doctrine would not find DOI. The Third Circuit, however, later reversed the Tax Court on other grounds.²³⁷ This reversal suggests that other courts may not follow the Tax Court's holding in similar discharge of debt scenarios.

VII. THE LOAN PROCEEDS RATIONALE SUPPORTS INCLUSION OF ACQUISITION NONRECOURSE DEBT IN THE BASIS OF ACQUIRED PROPERTY

As application of the loan proceeds rationale to each of the discharge of debt scenarios illustrates, the loan proceeds rationale is the only rationale that finds gross income whenever the taxpayer has an accession to wealth. In addition, the underlying reasoning of the loan proceeds rationale provides justification for the long

²³² *Id.* at 1094.

²³³ *Id.* at 1091-94.

²³⁴ *Id.* at 1092-94.

²³⁵ *Id.* at 1094.

²³⁶ *Id.*

²³⁷ *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990), *rev'g* 92 T.C. 1084 (1989); *see supra* note 68 (discussing Third Circuit's *Zarin* decision).

established tax principle that the basis of acquired property includes acquisition nonrecourse debt.

A. Basis Represents After-Tax Dollars Invested in Property

Before explaining how the loan proceeds rationale supports inclusion of acquisition nonrecourse debt in the basis of acquired property, it is necessary to understand the meaning of basis. Section 1012 of the Code defines the “basis of property” as the “cost of such property.”²³⁸ In *Philadelphia Park Amusement Co. v. United States*,²³⁹ the Court of Claims defined the “cost of such property” as the taxpayer’s after-tax investment in the property.²⁴⁰

In *Philadelphia Park*, the taxpayer entered into a fifty-year franchise agreement with the City of Philadelphia to operate a passenger railway over a bridge that the taxpayer would build in order to transport customers to and from the taxpayer’s amusement park.²⁴¹ Prior to the expiration of the agreement, the bridge needed extensive repairs, but the taxpayer lacked the funds to make them.²⁴² In order to remain in operation, the taxpayer exchanged ownership of the bridge with the City of Philadelphia for a ten-year extension of the franchise term.²⁴³ As part of the exchange, the taxpayer reserved its right-of-way over the bridge and agreed to maintain its passenger railway for the duration of the franchise term.²⁴⁴ Three years prior to the expiration of the ten-year franchise agreement extension, the taxpayer ceased operating the railway and abandoned the remaining term of the franchise agreement.²⁴⁵

At issue in the case was the taxpayer’s basis in the ten-year franchise agreement extension upon which the taxpayer had claimed depreciation deductions and a loss from abandonment of the extension. The court therefore sought to determine the meaning of “cost of such property” as that term defined basis under the predecessor of section 1012 of the Code (“cost basis”). Initially, the court determined that the taxpayer had acquired the ten-year extension in exchange for the bridge in a taxable transac-

²³⁸ I.R.C. § 1012.

²³⁹ 126 F. Supp. 184 (Ct. Cl. 1954).

²⁴⁰ See *id.* at 188-89.

²⁴¹ *Id.* at 185-86.

²⁴² *Id.* at 186.

²⁴³ *Id.*

²⁴⁴ *Id.*

²⁴⁵ *Id.*

tion.²⁴⁶ The court then noted that there were two approaches to determining the basis of property acquired in a taxable transaction.²⁴⁷ Under the first approach, the cost basis of property received in a taxable exchange is the fair market value of the property exchanged.²⁴⁸ Under the second approach, the cost basis is the fair market value of the property received.²⁴⁹

The court adopted the first approach. It observed that on the exchange of property under the predecessor to section 1001(a) of the Code, gain or loss is computed by subtracting the taxpayer's adjusted basis from the amount realized on the exchange.²⁵⁰ Under the predecessor to section 1001(b) of the Code, the amount realized is the fair market value of the property received.²⁵¹ If the amount realized exceeds the taxpayer's basis, the taxpayer will realize a gain.²⁵² The court reasoned that the determination of the basis of the property received in the exchange must be consistent with the statutory formula for computing gain or loss in the exchange in which the taxpayer acquired the property.²⁵³

The court concluded that for the definition of cost basis to be consistent with the taxpayer's recognition of gain, the cost basis must be the same as the amount realized. If the cost basis of the property equals the fair market value of the exchanged property, the taxpayer will receive either an unwarranted stepped-up or stepped-down basis in the acquired property. Thus, if the fair market value of the exchanged property exceeds the amount realized, the basis of the acquired property will be greater than the amount subject to tax under section 1001(a) of the Code.²⁵⁴ Upon a subsequent disposition of the acquired property, the taxpayer will be able to reduce a gain or create a loss by the amount of the additional basis upon which she paid no tax. However, if the amount realized exceeds the fair market value of the exchanged property, the acquired property's basis will be less

²⁴⁶ *Id.* at 187.

²⁴⁷ *Id.* at 188.

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ *Id.*

²⁵¹ *Id.* at 188-89.

²⁵² See I.R.C. § 1001(c) (stating that except as otherwise provided in Code, entire amount of realized gain will be recognized).

²⁵³ *Philadelphia Park*, 126 F. Supp. at 188.

²⁵⁴ See *id.*

than the amount that had been subject to tax under section 1001(a) of the Code.²⁵⁵ If the taxpayer later disposes of the acquired property, the taxpayer will have to increase a gain or reduce a loss by an amount not included in its basis, but upon which she has paid tax.²⁵⁶

The court further explained the rationale for its holding as follows:

By holding that the fair market value of the property received in a taxable exchange is the cost basis, the above discrepancy is avoided and the basis of the property received will equal the adjusted basis of the property given plus any gain recognized, or that should have been recognized, or minus any loss recognized, or that should have been recognized.²⁵⁷

Thus, the court's holding in *Philadelphia Park* established that cost basis means the taxpayer's after-tax investment in property.²⁵⁸

B. Applying the First Step of the Loan Proceeds Rationale to Inclusion of Acquisition Nonrecourse Debt in the Basis of Acquired Property

Under the first step of the loan proceeds rationale, gross income does not result because the economic benefit received by the taxpayer in the form of the borrowed funds is offset by a simultaneous obligation to repay the amount borrowed.²⁵⁹ The time span between the original borrowing and repayment is irrelevant because the taxpayer's simultaneous promise to repay the loan is respected throughout the loan term.²⁶⁰ If the taxpayer satisfies the debt, repayment will be made from her own funds,²⁶¹ which are after-tax dollars.²⁶² Stated differently, under the first

²⁵⁵ See *id.*

²⁵⁶ *Id.*

²⁵⁷ *Id.* at 188-89.

²⁵⁸ *Id.*

²⁵⁹ *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983).

²⁶⁰ *Cf. Brannen v. Commissioner*, 722 F.2d 695, 701 (11th Cir. 1984) (stating that limited partner's basis in partnership property includes allocable share of nonrecourse debt so long as property's fair market value reasonably approximates principal amount of debt). Of course, the loan must bear adequate interest that the taxpayer would likely be required to pay during the term of the loan. Otherwise, the taxpayer would be subject to the below-market loan provisions of the Code. See I.R.C. § 7872.

²⁶¹ This is not to say that the taxpayer cannot repay a loan with the proceeds of another loan from a different lender. In the end, if the taxpayer is to satisfy the debt, she will have to repay either the original loan or a subsequent loan incurred to repay the original loan with her own funds.

²⁶² A taxpayer's money or cash is always presumed to be after-tax dollars

step of the loan proceeds rationale, the taxpayer is given, in effect, an advance credit for her promise to repay the loan with after-tax dollars. Therefore, the loan proceeds are not taxed when received because they are treated as if they were the taxpayer's own after-tax dollars.²⁶³

Similarly, although a taxpayer who purchases property with acquisition nonrecourse debt receives the economic benefits of ownership of the acquired property for which she has not yet paid, gross income does not result because of her simultaneous promise to pay for the property by satisfying the debt.²⁶⁴ In this case, the taxpayer is treated as the owner of the property because she is given, in effect, an advance credit for paying for the property with her own after-tax dollars.²⁶⁵ Thus, even though the taxpayer has not yet paid for the property, she is entitled to the tax benefits of basis because her promise to pay for the property by

because the basis of money is its face value. Basis represents a taxpayer's after-tax investment in property. See *Philadelphia Park*, 126 F. Supp. at 188; *supra* notes 239-58 and accompanying text (discussing *Philadelphia Park*).

One commentator has explained how cash, by definition, must be an after-tax investment in property. The author explained the rationale for his conclusion as follows:

The reason that cash must have basis equal to face value and the function cash serves in the tax system reflect why cash is justified in having basis equal to face value. When the income tax system is allowed to operate, cash is, as was said earlier, after-tax cash almost by definition. The cash passed through a recognition event to reach A's hands It may be in the next preceding transaction, if for instance the \$40 was acquired as wages for labor, or it may require looking back through an extended series of transactions. But recognition at one time or another will be found.

John J. Potts, *Did Your Law Professor Tell You Basis Means Cost? The Recognition Theory of Basis*, 22 VAL. U. L. REV. 233, 269 (1988).

²⁶³ Of course, the taxpayer might repay the loan with money upon which she may never be required to pay tax. For example, a taxpayer could repay the loan with funds received as a gift, which the Code excludes from gross income. See I.R.C. § 102 (excluding value of property acquired by gift, bequest, devise, or inheritance from gross income). In that event, the taxpayer should also be given an advance credit for repaying the loan with after-tax dollars. This is because the term "after-tax dollars" means that the taxpayer is not required to pay tax on those dollars.

²⁶⁴ *Commissioner v. Tufts*, 461 U.S. 300, 307-08 (1983).

²⁶⁵ An owner of property is not taxed on the economic benefits of ownership. Cf. *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371, 381 (1934) (holding that Congress may not tax rental value of owner-occupied space).

satisfying the debt with after-tax dollars is respected.²⁶⁶

Because nonrecourse debt is included in the basis of the acquired property, the taxpayer is entitled to all of the tax benefits of basis. For example, when the taxpayer disposes of the property, gain or loss is measured by subtracting the adjusted basis in the property from the amount realized.²⁶⁷ In the case of depreciable property, the taxpayer may depreciate the cost of the property over its applicable recovery period.²⁶⁸

The tax benefits incident to the inclusion of acquisition nonrecourse debt in the basis of the acquired property have induced some taxpayers to “acquire” property with acquisition nonrecourse debt that exceeds the property’s fair market value (“excessive acquisition nonrecourse debt cases”).²⁶⁹ These taxpayers are motivated to enter these transactions because the greater the acquisition nonrecourse debt included in the depreciable basis of the property, the greater the allowable depreciation deductions.²⁷⁰

In the excessive acquisition nonrecourse debt cases, the issue is whether and to what extent the taxpayer may include the acquisition nonrecourse debt in the basis of the secured property.²⁷¹ If the debt is treated as a cost of the property and included in its basis, the taxpayer may take corresponding depreciation deductions.²⁷² Generally, the courts have refused to acknowledge a depreciable basis in property or a “loan” created with acquisition nonrecourse debt unless the fair market value of the underlying property is approximately equal to the nonrecourse liability.²⁷³

²⁶⁶ *Crane v. Commissioner*, 331 U.S. 1, 11 (1947); *Brannen v. Commissioner*, 722 F.2d 695, 701 (11th Cir. 1984).

²⁶⁷ See I.R.C. § 1001(a); *supra* note 75 (providing text of § 1001(a)). The taxpayer realizes a gain on the disposition of property if the amount realized exceeds the adjusted basis of the property. The taxpayer realizes a loss on the disposition of property if the adjusted basis exceeds the amount realized.

²⁶⁸ See I.R.C. § 168.

²⁶⁹ See, e.g., *Lebowitz v. Commissioner*, 917 F.2d 1314 (2d Cir. 1990); *Odend’hal v. Commissioner*, 748 F.2d 908 (4th Cir. 1984), *cert. denied*, 471 U.S. 1143 (1985); *Brannen*, 722 F.2d at 695; *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976).

²⁷⁰ *Brannen*, 722 F.2d at 701.

²⁷¹ *Id.*; *Estate of Franklin*, 544 F.2d at 1048-49.

²⁷² See *Hager v. Commissioner*, 76 T.C. 759, 773 (1981); *Mayerson v. Commissioner*, 47 T.C. 340, 351-52 (1966).

²⁷³ See *Odend’hal*, 748 F.2d at 912. In commenting on this point the Fourth Circuit stated:

The rationale for this approach is based upon economic reality. If there is equal value associated with an acquisition nonrecourse debt, the taxpayer is likely to pay the debt in order to retain the property. The courts have reasoned that if the taxpayer must pay more than the property is worth to retain ownership, there is no incentive for the taxpayer to satisfy the debt.²⁷⁴ Thus, the courts have concluded that the taxpayer is not entitled to include in basis any nonrecourse debt that the taxpayer would not pay.²⁷⁵ As a result, the courts have correctly denied depreciation deductions and interest deductions related to this type of nonrecourse liability.²⁷⁶

The courts' rationale in the excessive acquisition nonrecourse debt cases is consistent with the first step of the loan proceeds rationale. At the crux of the courts' holdings in these cases is whether to give the taxpayer an advance credit for an after-tax investment in the acquired property.²⁷⁷ Under the first step of the loan proceeds rationale, an advance credit for an after-tax investment is the crucial factor that prevents the taxpayer from being taxed on the receipt of loan proceeds. In order to give the taxpayer an advance credit for an after-tax investment, the integrity of the taxpayer's promise to repay the debt must be respected. If that is not the case, then the taxpayer's promise to repay the debt does not offset the economic benefit she received in the form of the loan proceeds.²⁷⁸ Accordingly, the taxpayer

If, as a matter of fact, the fair market value of the property is less than that financed by a nonrecourse loan, the authorities hold that the principal of the nonrecourse loan which exceeds fair market value does not represent a real investment in the property by a taxpayer and he may not include that amount in his basis for depreciation. In addition, the interest paid on the loan is not allowable as an interest deduction.

Id. (citations omitted).

²⁷⁴ See *Saviano v. Commissioner*, 765 F.2d 643, 646 (7th Cir. 1985); *Estate of Franklin*, 544 F.2d at 1048.

²⁷⁵ See sources cited *supra* note 274.

²⁷⁶ *E.g.*, *Brannen v. Commissioner*, 722 F.2d 695, 701 (11th Cir. 1984) (stating that purchaser who has no real investment in property cannot depreciate it); *Estate of Franklin*, 544 F.2d at 1049 (denying taxpayer interest deductions with respect to nonrecourse debt that exceeds fair market value of secured property).

²⁷⁷ See *supra* notes 269-76 and accompanying text.

²⁷⁸ *United States v. Rochelle*, 384 F.2d 748, 751 (5th Cir. 1967) (recognizing loans incurred without intent to repay as gross income), *cert. denied*, 390 U.S. 946 (1968).

has realized an accession to wealth that should be included in her gross income.²⁷⁹

Applying the first step of the loan proceeds rationale to the inclusion of acquisition nonrecourse debt in the basis of the secured property, the taxpayer is given an advance credit for an after-tax investment in property because of her simultaneous promise to repay the debt. In the excessive nonrecourse debt cases, the integrity of the taxpayer's promise is not respected. Therefore, the taxpayer's promise to repay the debt does not justify the inclusion of the acquisition nonrecourse debt in the basis of the secured property.

C. Applying the Second Step of the Loan Proceeds Rationale to Disposition of Property Subject to Acquisition Nonrecourse Debt

Another way to view the second step of the loan proceeds rationale is to consider it as a correction mechanism for a prior tax consequence that time proves was incorrect. During the term of a loan, the taxpayer enjoys all of the economic benefits of the loan proceeds tax-free because of her simultaneous obligation to repay the debt with after-tax dollars. Under the second step of the loan proceeds rationale, a subsequent forgiveness of all or part of the loan that releases the taxpayer from any further obligation to repay the debt triggers gross income. Because the taxpayer has failed to convert her advance credit for paying the debt with after-tax dollars into an actual after-tax payment, it is no longer appropriate to treat the loan proceeds as if they were the taxpayer's own after-tax dollars. Therefore, in retrospect, the taxpayer was not entitled to enjoy the economic benefits of the loan proceeds tax-free. This situation is corrected after the fact by requiring the taxpayer to include the forgiven loan proceeds as an amount realized on the disposition of the secured property. This, in effect, converts the loan proceeds into after-tax dollars because the loan proceeds are now taxable.

Similarly, as long as the acquisition nonrecourse debt remains outstanding, the taxpayer enjoys the economic benefits of owner-

²⁷⁹ In the excessive acquisition nonrecourse debt cases, it was clear from the economics of each transaction that the parties never intended the taxpayer to become the owner of the property. In reality, the "acquisition" was a tax gimmick to allow the taxpayer "acquiring" the property to take improper depreciation and/or interest deductions as a result of the nonrecourse debt. See *Brountas v. Commissioner*, 73 T.C. 491 (1979), *vacated*, 692 F.2d 152, and *aff'd in part and rev'd in part*, 693 F.2d 281 (1982).

ship of the property tax-free because of her simultaneous obligation to pay for the property with after-tax dollars. Because the taxpayer has failed to convert her advance credit for paying for the property with after-tax dollars into an actual after-tax investment in the property, it is no longer appropriate to treat the original acquisition nonrecourse debt as the cost of the property included in the property's basis. Therefore, in retrospect, the taxpayer was not entitled to enjoy the economic benefits of ownership of the acquired property tax-free.

In this case, the situation is corrected after the fact by requiring the taxpayer to include the debt relief in the amount realized on the disposition of the property. By requiring the taxpayer to include the debt relief in the amount realized, the prior value of the property received (the loan proceeds) is taxed to the extent that the debt relief exceeds the property's adjusted basis.²⁸⁰ As a result of subjecting the debt relief to tax, the taxpayer simultaneously converts her advance credit for an after-tax investment in the property into an after-tax investment in the property. Therefore, in computing gain on the transfer of the property, it is appropriate for the adjusted basis of the secured property to include the original debt as adjusted by allowable depreciation deductions.²⁸¹

CONCLUSION

Gross income is the starting point of our tax base. Under the Supreme Court's definition of gross income, a taxpayer should realize gross income whenever she has an accession to wealth.²⁸² Accessions to wealth can take many forms. This Article has focused on accessions to wealth in the form of the discharge of debt under three different scenarios. For each scenario, the courts have applied a different test to determine whether the discharge of debt results in gross income. The three tests are: (1) the *Kirby Lumber* doctrine; (2) the double deduction rationale; and (3) the loan proceeds rationale.

The *Kirby Lumber* doctrine and the double deduction rationale are deficient because they do not always find gross income when a

²⁸⁰ See I.R.C. § 1001(a).

²⁸¹ See I.R.C. § 1016(a)(2).

²⁸² See *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 431 (1955); see also I.R.C. § 61 (defining gross income as income from whatever source derived).

taxpayer realizes an accession to wealth from the discharge of debt. When these rationales fail, it is because they do not take into account that if the taxpayer does not include in her gross income the tax-free receipt of loan proceeds that she will never repay, those proceeds will forever escape taxation. In contrast, the loan proceeds rationale correctly finds gross income in all three discharge of debt scenarios. This is because it focuses on the tax-free use of the loan proceeds during the term of the loan, and ties realization of gross income to an event that cancels the taxpayer's promise to repay the loan.

Further, the soundness of the loan proceeds rationale extends beyond its success in finding gross income in each discharge of debt scenario in which a taxpayer realizes an accession to wealth. The rationale also provides justification for the long established tax principle that the basis of acquired property includes acquisition nonrecourse debt.

The first step of the loan proceeds rationale allows the taxpayer to include the debt in the basis of the property because she has promised to make an after-tax investment in the property by repaying the debt. The second step of the loan proceeds rationale permits the taxpayer to enjoy the economic benefits of ownership of the property tax-free for as long as the acquisition nonrecourse debt remains outstanding because she has a simultaneous obligation to pay for the property with after-tax dollars. When the taxpayer subsequently transfers the property in full satisfaction of the debt, however, the loan proceeds rationale requires her to include the debt relief in the amount realized on the disposition of the property. This converts the acquisition nonrecourse debt into an after-tax investment in the secured property because the prior value received in the form of the acquired property is now taxable. Therefore, in computing gain on the transfer of the property, the loan proceeds rationale allows the taxpayer to include the original debt, as adjusted by allowable depreciation deductions, in the property's adjusted basis.