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**The Applicability of I.R.C. Section 108 to  
Cancellation of Indebtedness by a  
Transfer of Property**

by

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# NOTES

## THE APPLICABILITY OF I.R.C. SECTION 108 TO CANCELLATION OF INDEBTEDNESS BY A TRANSFER OF PROPERTY

### I. INTRODUCTION

Since 1931 it has been established that income includes the amount of the taxpayer's indebtedness that has been cancelled.<sup>1</sup> Although this rule is simply stated, its application to the myriad of factual situations that arise has led to the compilation of a confusing body of law.<sup>2</sup> One area of complexity that has received inadequate discussion by the judiciary and commentators<sup>3</sup> is the interplay between Internal Revenue Code (hereinafter I.R.C.) section 108<sup>4</sup> relating to the exclusion of discharge of indebtedness income

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1. *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931)(purchase by taxpayer of its own bonds at less than their face value held to be ordinary income to the extent of the difference between the face value and the purchase price).

2. See Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225 (1959); Eustice, *Cancellation of Indebtedness Redux: The Bankruptcy Tax Act of 1980 Proposals—Corporate Aspects*, 36 Tax L. Rev. 1 (1980).

3. No commentary has been found on the precise issues presented herein other than that in *Spartan Petroleum Co. v. United States*, 437 F. Supp. 733 (D.S.C. 1977) and *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979). One possible reason for the lack of litigation could be the failure of taxpayers to preserve their claim for application of Internal Revenue Code (hereinafter cited as I.R.C.) section 108. See *infra* note 181.

4. I.R.C. § 108 (1981) states in pertinent part:

(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—

- (A) the discharge occurs in a title 11 case,
- (B) the discharge occurs when the taxpayer is insolvent, or
- (C) the indebtedness discharged is qualified business indebtedness.

I.R.C. § 108(a) (1981)(emphasis added). Section 108 goes on to define several key terms:

(d) MEANING OF TERMS . . .

- (1) INDEBTEDNESS OF THE TAXPAYER— . . . any indebtedness—
  - (A) for which the taxpayer is liable, or
  - (B) subject to which the taxpayer holds property.

- (2) TITLE 11 CASE— . . . a case under title 11 of the United States Code (relat-

and I.R.C. section 1001<sup>6</sup> regarding the recognition of gain on the sale or other disposition of property.

The conflict between I.R.C. sections 108 and 1001 arises in the factual context of a taxpayer transferring property<sup>8</sup> to a creditor in satisfaction of either a recourse<sup>7</sup> or a nonrecourse<sup>8</sup> indebtedness. For example, suppose that the taxpayer has recourse or nonrecourse indebtedness with a face amount<sup>9</sup> of \$100, and property that has a fair market value<sup>10</sup> of \$75 and an adjusted basis<sup>11</sup> of \$25. If the taxpayer transfers the property to the creditor in com-

ing to bankruptcy) . . . .

(3) **INSOLVENT**— . . . the excess of liabilities over the fair market value of assets . . . .

(4) **QUALIFIED BUSINESS INDEBTEDNESS**—Indebtedness . . . shall be treated as qualified business indebtedness if (and only if)—

(A) the indebtedness was incurred or assumed—

(i) by a corporation, or

(ii) by an individual in connection with property used in his trade or business . . . .

Section 108 does not define "discharge . . . of indebtedness," nor do the regulations thereunder. See Treas. Reg. § 1.108(a)-1 (1956). However, the Treasury Department has defined that term by example: "If . . . an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realized income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value." Treas. Reg. § 1.61-12(a)(1957).

5. I.R.C. § 1001 (1976) states in part:

(a) **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 section 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.

(b) **AMOUNT REALIZED**— . . the sum of any money received plus the fair market value of the property (other than money) received . . . .

(c) **RECOGNITION OF GAIN OR LOSS**—Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

Adjusted basis is defined as the cost of the property adjusted by expenditures properly chargeable to the capital account (an improvement as opposed to a repair), depreciation, and by other less significant adjustments. See I.R.C. §§ 1011(a), 1012, 1016(a)(1976). There are exceptions to that definition. See, e.g., I.R.C. § 1014 (1981); I.R.C. § 1015 (1976).

6. In this situation, property is used to mean anything other than cash.

7. Recourse indebtedness is debt for which the taxpayer is personally liable.

8. Nonrecourse indebtedness is a secured debt for which the taxpayer is not personally liable. Instead, the creditor may satisfy the indebtedness only by execution upon the property that secures the debt. This commonly arises in the context of inheritance of property that is subject to a security interest. See *Crane v. Commissioner*, 331 U.S. 1, 3, 14 (1947).

9. Face amount is meant here to denote the unpaid principal, exclusive of interest.

10. Fair market value is generally defined as the price that a willing buyer would pay to a willing seller. See *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184 (Ct. Cl. 1954).

11. Adjusted basis is the cost to the taxpayer of acquiring the property, increased and decreased by certain items as detailed in I.R.C. § 1011. See *supra* note 5. The adjusted basis

plete satisfaction of the indebtedness, the tax consequences to the transferor taxpayer can be drastically different depending on whether the transfer is treated as "discharge of indebtedness"<sup>12</sup> or as a "sale or other disposition of property."<sup>13</sup>

An analysis of how this difference in tax treatment arises must begin with I.R.C. section 61.<sup>14</sup> Section 61 is the code provision that defines gross income. This is the starting point for any imposition of federal income tax. Under section 61, gross income includes "all income from whatever source derived, including . . . (3) [g]ains from dealings in property<sup>15</sup> . . . [and] (12) [i]ncome from discharge of indebtedness."<sup>16</sup> Based on section 61 alone, it seems that it should make little difference whether debt cancellation by property transfer is categorized as discharge of indebtedness, or as a dealing in property, since both constitute gross income. Section 61 does, however, provide that an item is not gross income if it is specifically excluded under some other section.<sup>17</sup> Pursuant to that provision, Congress has enacted I.R.C. section 108.<sup>18</sup> Under section 108, income from discharge of indebtedness can be excluded from gross income under certain circumstances.<sup>19</sup>

may be used by the taxpayer to offset amounts received from a sale or other disposition of property in calculating the gain or loss from the transaction. I.R.C. § 1001(a) (1976).

12. I.R.C. § 108 (1981). For a discussion of the meaning of "discharge of indebtedness," see *infra* notes 23-33 and accompanying text.

13. I.R.C. § 1001 (1976). For a discussion of the application of "sale or other disposition" in this context see *infra* notes 34-37 and accompanying text.

14. I.R.C. § 61 (1976).

15. "Sale or other dispositions of property" is included in "dealings in property." Treas. Reg. § 1.61-6(a) (1957).

16. I.R.C. §§ 61(a), 61(a)(3), 61(a)(12) (1976).

17. I.R.C. § 61(a) (1976).

18. I.R.C. § 108 (1981). See *supra* note 4 for a portion of the text of section 108.

19. See *supra* note 4. For section 108 to apply, the taxpayer must be under the jurisdiction of a bankruptcy court, be insolvent immediately before the discharge, be liable for debt that arose "in connection with property used in his trade or business," or be a corporate debtor. I.R.C. §§ 108(d)(2), 108(d)(3), 108(d)(4) (1981).

An insolvent or bankrupt taxpayer must reduce certain tax attributes to the extent of the exclusion from gross income in the following order: net operating loss for the current period and any carryovers, certain credit carryovers, capital loss carryovers, basis of property, and foreign tax credit carryovers. See *id.* §§ 108(b)(1), 108(b)(2). The taxpayer may elect to reduce the basis of his property first. *Id.* § 108(b)(5). For bankrupt and insolvent taxpayers, the amount of income excluded under section 108 is not limited by the availability of tax attributes to be reduced. *Id.* § 108(a)(1).

If the taxpayer seeks exclusion under the qualified business indebtedness provision of section 108, he must elect to do so. *Id.* § 108(d)(4)(B). Furthermore, such taxpayer must reduce his basis in depreciable property to the extent of his exclusion elected, and he may not reduce any other tax attribute. *Id.* § 108(c)(1)(A). Also, the exclusion is limited to the taxpayer's adjusted basis in depreciable property. *Id.* § 108(c)(2).

Additionally, it should be noted that any reduction in basis caused by section 108 will generally be recaptured under section 1245 or 1250 as ordinary income upon disposition of the reduced basis property, even if the property is not section 1245 or 1250 property. See *id.* §§

There is, however, no analogous exclusionary provision applicable if the transfer of property to satisfy a debt is considered to be a sale or other disposition of property under section 1001,<sup>20</sup> instead of cancellation of indebtedness. Therefore, it would be advantageous to the taxpayer in most instances<sup>21</sup> to attempt to fall within the protection of section 108.

The issue, then, is whether a taxpayer who cancels indebtedness by transferring property to the creditor can exclude any gain realized<sup>22</sup> on the transfer by operation of I.R.C. section 108, rather than recognize the gain realized under section 1001. The resolution of that issue depends upon whether the transfer of property to cancel a debt is categorized as discharge of indebtedness (to which section 108 applies), rather than as a sale or other disposition of property (to which section 1001 applies). Under existing interpretations of the law, section 108 does not generally apply and all gain realized must be recognized as a disposition of property under section 1001. The judiciary, the Treasury Department, and the Internal Revenue Service (hereinafter the Service) should reverse their position and allow exclusion under section 108 of income from debt cancellation by property transfer. In the absence of such a policy reversal, Congress should amend section 108 to specifically apply to cancellation of debt by transfer of property.

## II. CURRENT TREATMENT OF DEBT DISCHARGE BY PROPERTY TRANSFER

### A. Recourse Indebtedness

In *Spartan Petroleum Co. v. United States*,<sup>23</sup> the court provided a clear explanation of the circumstances under which debt cancellation constitutes

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1017(d)(1), 1245(a)(2), 1250(a)(1)(A)(ii). The reason for this recapture is that section 108 is intended to merely postpone gain recognition, not eliminate it. See H. R. REP. No. 833, 96th Cong., 2d Sess. 8 (1980); S. REP. No. 1035, 96th Cong., 2d Sess. 2-3 (1980). The effect of this on some occasions, though, is to transform currently taxable capital gain into later taxed ordinary income. For instance, if a debt cancellation by property transfer is considered a disposition of property to which section 108 does not apply, then the gain may be capital under section 1231. See *id.* § 1231 (1981). Yet, if section 108 does apply, the later recognized gain by lower net operating loss carryovers, lower carryovers of certain credits, lower capital loss carryovers, lower depreciation allowances due to basis reduction, and basis reduction recapture upon disposition of the property whose basis was reduced will generally be ordinary income. See *id.* §§ 108(b)(2), 1017(d)(1), 1245(a)(2), 1250(a)(1)(A)(ii).

20. There are, however, some very specific exclusionary provisions that are applicable to I.R.C. section 1001, such as I.R.C. section 1034 regarding rollover of gain on sale of principal residence. I.R.C. § 1034 (1981).

21. It may be best to avoid exclusion under section 108 if the taxpayer has expiring net operating losses and anticipates future income since section 108 usually operates to defer recognition of income rather than to completely exclude it. See *supra* note 19.

22. Gain realized is the extent of debt cancellation without consideration for whether the gain is characterized as discharge of indebtedness. See Treas. Reg. § 1.61-12(a)(1957). If there is a sale or other disposition of property, the gain realized is the amount realized, less the adjusted basis of the property. I.R.C. § 1001(a)(1976). See *supra* note 5.

23. 437 F. Supp. 733, 736 (D.S.C. 1977).

“income from discharge of indebtedness,”<sup>24</sup> and when it causes “gain from the sale or other disposition of property.”<sup>25</sup> In this connection, the court noted that debt cancellation can generate income in one of two ways; either as a “direct source of taxable income” or as a “medium through which other types of income arise.”<sup>26</sup>

Debt cancellation is a direct source of income when an entire debt is cancelled by “the transfer from the debtor to the creditor of cash . . . having a value of less than the face amount of the debt.”<sup>27</sup> Thus, if a creditor accepts \$75 in full satisfaction of a \$100 debt, the debtor has \$25 of income.<sup>28</sup> This is the form of debt cancellation that constitutes “income from discharge of indebtedness” under I.R.C. section 61(a)(12),<sup>29</sup> and hence is potentially<sup>30</sup> excludable under I.R.C. section 108. This concept can also apply to the original example given in this Note:<sup>31</sup> a debt with a face amount of \$100 is satisfied by the transfer to the creditor of property having a fair market value of \$75 and an adjusted basis of \$25. In that situation, discharge of indebtedness income to the debtor is generated to the extent of \$25 (\$100 face amount of debt cancelled, less \$75 fair market value transferred)<sup>32</sup> if the debt is recourse. It will be fully explained below why there may be no discharge of indebtedness income if the debt cancelled is non-recourse.<sup>33</sup>

Cancellation of debt can also be a medium through which other income arises. The court in *Spartan*, provided a clear example of this form of income:

[I]f an employee owes his employer \$100 and renders \$100 worth of services for the employer in return for the employer's cancellation of the indebtedness, the employee has received personal service income of \$100. Sec. 61(a)(1). That income is not cancellation of indebtedness income because the cancellation is merely the medium for payment of other income, and is not the source of the income itself.<sup>34</sup>

This principle can also apply to the example used in this Note.<sup>35</sup> If \$100 of a recourse debt is cancelled in exchange for property having a fair market value of \$75 and an adjusted basis of \$25 the debtor must recognize \$50 (\$75 fair market value of property transferred, less \$25 adjusted basis) of gain

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24. I.R.C. §§ 61(a)(12) (1976), 108 (1981).

25. I.R.C. § 1001(a) (1976). See also I.R.C. § 61(a)(3) (1976).

26. *Spartan Petroleum Co. v. United States*, 437 F. Supp. at 736.

27. *Id.*

28. *Id.*

29. *Id.*

30. See *supra* notes 4, 19.

31. See *supra* text accompanying notes 9-13.

32. See *Spartan Petroleum Co. v. United States*, 437 F. Supp. at 736.

33. See *infra* notes 69-72 and accompanying text.

34. *Spartan Petroleum Co. v. United States*, 437 F. Supp. at 736.

35. See *supra* text accompanying notes 9-13.

pursuant to I.R.C. section 1001<sup>36</sup> since the debt cancellation is merely a medium of payment for the disposition of the property. If the debt is non-recourse, it will be shown below that the gain under section 1001 will be \$75 (\$100 face amount of debt cancelled, less \$25 adjusted basis).<sup>37</sup> Such amounts recognized under section 1001 are not excludable pursuant to section 108 under current law since they are not income from the discharge of indebtedness.<sup>38</sup>

In *Spartan*, the court applied these principles to the cancellation of recourse indebtedness.<sup>39</sup> There, the plaintiff taxpayer (Spartan) had gasoline distribution agreements having an adjusted basis of \$100,000 with the Atlantic Richfield Company (hereinafter ARCO), and had incurred indebtedness owing to ARCO.<sup>40</sup> ARCO subsequently sought to cancel Spartan's distributor agreements.<sup>41</sup> After setting the amount of damages that ARCO would owe Spartan at \$1.6 million, Spartan persuaded ARCO to simply cancel Spartan's recourse indebtedness to ARCO in the amount of \$200,000, and pay Spartan the excess of \$1.4 million in cash, to cancel the distributor agreements.<sup>42</sup> On its tax return, Spartan reported the \$200,000 of debt cancellation as excludable under I.R.C. section 108.<sup>43</sup> In denying the exclusion, the *Spartan* court made two holdings.

First, the court held that under the doctrine of *United States v. Davis*,<sup>44</sup> the fair market value of the property given by Spartan (the distribution agreements) is equal to the value received by Spartan (\$1.4 million cash, plus \$200,000 debt cancellation).<sup>45</sup> Since the value of the cash and debt cancellation received by Spartan was assumed to equal the value of the agreements given, there was no discharge of indebtedness for less than its face value.<sup>46</sup> If the distribution agreements had had a fair market value of only \$1.5 million, then the court may have found that there was \$100,000 of discharge of indebtedness income potentially excludable under section 108 (\$1.5 million value given, less \$1.4 million cash received equals \$100,000 of fair market value transferred net of cash received, compared to \$200,000 of debt cancelled).<sup>47</sup> The court made such a holding impossible by ruling that it is "axiomatic" that the value given equals the value received in an arms-

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36. *Spartan Petroleum Co. v. United States*, 437 F. Supp. at 736.

37. See *infra* note 74 and accompanying text.

38. See Treas. Reg. § 1.1001-2(c) example 8 (1980); *Spartan Petroleum Co. v. United States*, 437 F. Supp. at 737.

39. *Spartan Petroleum Co. v. United States*, 437 F. Supp. at 734.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *United States v. Davis*, 370 U.S. 65 (1962).

45. *Spartan Petroleum Co. v. United States*, 437 F. Supp. at 736.

46. *Id.* at 736-37.

47. *Id.* at 736.

length transaction.<sup>48</sup>

Second, the court held that the cancellation of indebtedness was merely a medium of payment for the transfer of property (the distribution agreements), and was therefore part of the amount realized in a taxable disposition of property under I.R.C. section 1001.<sup>49</sup> Since the debt cancellation was part of a disposition of property, and not discharge of indebtedness income, it was not excludable under section 108.<sup>50</sup>

The court's analysis in *Spartan* is consistent with the income tax regulations promulgated by the Treasury Department,<sup>51</sup> at least as to the court's second holding. Treasury Regulation section 1.1001-2(a)(2) stipulates that the amount realized in satisfaction of a recourse liability does not include any amount that is considered income from discharge of indebtedness.<sup>52</sup> Pursuant to that rule, the regulations go on to show that if property worth \$6000 is transferred to a creditor in complete satisfaction of a recourse liability with a face amount of \$7500, then the amount realized for purposes of gain under section 1001 is \$6000, and income from discharge of indebtedness is \$1500 (which amount should be potentially excludable under section 108).<sup>53</sup> Finally, the regulations provide that the basis reduction required under section 108<sup>54</sup> in the case of recourse debt cancellation by property transfer is the amount by which the debt cancelled exceeds the fair market value of the property transferred by the debtor (\$1500 in the above example).<sup>55</sup> These regulations are in agreement with the *Spartan* court's analysis of what constitutes discharge of indebtedness income and what is gain on the disposition of property.<sup>56</sup>

Be that as it may, the regulations appear to contradict the *Spartan* court's first holding regarding the axiom that fair market value received is equal to fair market value given since the regulations are based on a situation in which the value given by the debtor is less than the value received (the amount of debt cancellation).<sup>57</sup> This disagreement is caused by a difference between the transaction being dealt with by the *Spartan* court and the transaction which is delineated in the regulations. In *Spartan*, the court was dealing with a negotiated arms-length agreement which was designed to be an equal exchange, so the amounts exchanged were equal and there was no discharge of indebtedness income.<sup>58</sup> The regulations envision a situation in

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48. *Id.*

49. *Id.* at 736-37.

50. *Id.*

51. Treas. Reg. §§ 1.1001-2(a)(2), 1.1001-2(c) example 8 (1980); 1.1017-1(b)(5) (1956).

52. Treas. Reg. § 1.1001-2(a)(2) (1980).

53. Treas. Reg. § 1.1001-2(c) example 8 (1980).

54. *See supra* note 19.

55. Treas. Reg. § 1.1017-1(b)(5) (1956).

56. *See supra* text accompanying notes 23-39.

57. *See supra* text accompanying notes 44-48, 53.

58. *See Spartan Petroleum Co. v. United States*, 473 F. Supp. at 734.

which a financially troubled debtor is seeking a compromise from a creditor who wants to salvage what he can.<sup>59</sup> In that scenario, the values exchanged are not designed to be equal; discharge of indebtedness income is intended by the parties, so the *Davis* rule<sup>60</sup> does not apply. Therefore, when the debtor is seeking exclusion under the insolvency provision of section 108<sup>61</sup> he need not worry about the *Davis* rule preventing any discharge of indebtedness income from arising since he is in the financial situation contemplated by the regulations.<sup>62</sup> If, however, the debtor seeks exclusion under the qualified business indebtedness provision of section 108,<sup>63</sup> and he is not financially troubled, then he may have difficulty proving the existence of discharge of indebtedness income due to *Davis*<sup>64</sup> since he would be in the sound financial situation contemplated by the court in *Spartan*.<sup>65</sup>

Other cases<sup>66</sup> covering related matters are in agreement with *Spartan*<sup>67</sup> and the regulations.<sup>68</sup> The general rule under current interpretation, therefore, is that property transfers in cancellation of recourse debt result in treatment under I.R.C. section 1001 as gain or loss on the sale or other disposition of property to the extent of the fair market value of the property transferred by the debtor taxpayer. Only the *excess* of the face amount of the recourse debt cancelled over the value of the property transferred is discharge of indebtedness income which is potentially excludable under I.R.C. 108.

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59. See Treas. Reg. § 1.1001-2(c) example 8 (1980). Cf. *Spear Box Co. v. Commissioner*, 182 F. 2d 844, 846 (2d Cir. 1950).

60. See *United States v. Davis*, 370 U.S. 65, 72 (1962). See also *supra* text accompanying notes 44-48.

61. See *supra* notes 4, 19.

62. See Rev. Rul. 76-111, 1976-1 C.B. 214; *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95, 96 (5th Cir. 1934); *Washington Package Store, Inc. v. Commissioner*, 23 T.C.M. (CCH) 1805, 1809-10 (1964); *Bialock v. Commissioner*, 35 T.C. 649, 660 (1961).

63. See *supra* note 19.

64. Cf. *Parker v. Delaney*, 186 F.2d 455, 458 (1st Cir. 1950) (on voluntary transfer of mortgaged property to mortgagee, value of property was assumed to equal mortgage amount); *Commissioner v. Mesta*, 123 F.2d 986, 987 (3d Cir. 1941)(amounts received and given were presumed equal when property was transferred to satisfy an obligation for support during divorce); *Kenan v. Commissioner*, 114 F.2d 217, 218, 220 (2d Cir. 1940)(amounts received and given were presumed equal when property was transferred to satisfy a trust disposition).

65. *Spartan Petroleum Co. v. United States*, 473 F. Supp. at 7.

66. *E.g.*, *Helvering v. Hammel*, 311 U.S. 504, 505, 507-08 (1941)(foreclosure of recourse mortgage is sale of property); *R. O'Dell & Son Co., Inc. v. Commissioner*, 169 F. 2d 247, 247-48 (3d Cir. 1948)(foreclosure of recourse mortgage is sale of property); *Commissioner v. Electro-Chemical Engraving Co.*, 110 F. 2d 614, 615-16 (2d Cir. 1940)(foreclosure of recourse mortgage is sale of property); *Bialock v. Commissioner*, 35 T.C. 649, 660 (1961)(voluntary transfer of assets for recourse debt cancellation is sale of property); *Mendham Corp. v. Commissioner*, 9 T.C. 320, 320, 325 (1947)(foreclosure of recourse mortgage is sale of property).

67. 437 F. Supp. 733 (D.S.C. 1977).

68. Treas. Reg. §§ 1.1001-2(a)(2), -2(c) example 8 (1980), 1.1017-1(b)(5) (1956).

B. *Nonrecourse Debt*

In contrast to recourse debt cancellation, cancellation of nonrecourse debt is generally held to never constitute discharge of indebtedness income.<sup>69</sup> Hence, continuing with the example used earlier in this Note,<sup>70</sup> if \$100 of nonrecourse debt is cancelled in exchange for property having a fair market value of \$75 and an adjusted basis of \$25, and if the debt cancellation is considered as a direct source<sup>71</sup> of income, then there is no income generated.<sup>72</sup> However, it was earlier observed that such debt cancellation by property transfer is generally considered to be a medium for payment in a disposition of property.<sup>73</sup> If cancellation is therefore treated as a medium for payment, there is \$75 of gain (\$100 face amount cancelled and considered as payment, less \$25 adjusted basis).<sup>74</sup> In either situation, neither the courts nor the regulations treat any of the amount of debt cancelled as discharge of indebtedness income.<sup>75</sup>

This is in sharp contrast to the example involving recourse debt. In that situation, \$25 was discharge of indebtedness income potentially excludable under section 108.<sup>76</sup> The apparent theory relied upon by the authorities which hold that nonrecourse debt cancellation cannot generate cancellation of indebtedness income is that, since nonrecourse debt is not a liability of the taxpayer, its cancellation does not free any of the taxpayer's assets<sup>77</sup> and

69. See Treas. Reg. § 1.1001-2(c) example 7 (1980); *Estate of Delman v. Commissioner*, 73 T.C. 15, 39 (1979). See also *Crane v. Commissioner*, 331 U.S. 1, 3-4, 14 (1947); *Tufts v. Commissioner*, 651 F.2d 1058, 1059-60 (5th Cir. 1980); *Woodsam Assocs., Inc. v. Commissioner*, 198 F.2d 357, 358-59 (2d Cir. 1952); *Freeland v. Commissioner*, 74 T.C. 970, (1980); *Collins v. Commissioner*, 22 T.C.M. (CCH) 1467, 1471 (1963); *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519, 521 (1934); Rev. Rul. 76-111, 1976-1 C.B. 214.

70. See *supra* text accompanying notes 9-13.

71. See *supra* text accompanying notes 27-33.

72. See *Collins v. Commissioner*, 22 T.C.M. (CCH) at 1471; *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. at 521; *Petrovito, Tufts v. Commissioner: A Limitation on the Inclusion of Nonrecourse Liabilities in Amount Realized*, 11 CAP. U.L. REV. 265, 276 n. 48 (1982). But see *Bittker, Tax Shelters, Nonrecourse Debt and the Crane Case*, 33 TAX L. REV. 277, 282 (1978).

73. See *supra* text accompanying notes 34-38, 49-55.

74. See *Commissioner v. Tufts*, 103 S. Ct. 1826, 1833 (1983).

75. *E.g.*, *Helvering v. Hammel*, 311 U.S. 504, 505, 507-08 (1941)(foreclosure of recourse mortgage is sale of property); *R. O'Dell & Son Co., Inc. v. Commissioner*, 169 F.2d 247, 247-48 (3d Cir. 1948)(foreclosure of recourse mortgage is sale of property); *Commissioner v. Electro Chemical Engraving Co.*, 110 F. 2d 614, 615-16 (2d Cir. 1940)(foreclosure of recourse mortgage is sale of property); *Bialock v. Commissioner*, 35 T.C. 649, 660 (1961)(voluntary transfer of assets for recourse debt cancellation is sale of property); *Mendham Corp. v. Commissioner*, 9 T.C. 320, 320, 325 (1947)(foreclosure of recourse mortgage is sale of property).

76. See *supra* text accompanying notes 31-32.

77. The "freeing-of-the-assets" theory has generally been the basis for holding that discharge of indebtedness in general creates income. See *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931). This theory states that the taxpayer realizes an accession to wealth when assets are no longer offset by liabilities. *Id.*

is not, therefore, discharge of indebtedness income to the taxpayer.<sup>78</sup>

The United States Supreme Court addressed the issue of non-recourse debt cancellation in *Commissioner v. Tufts*.<sup>79</sup> In *Tufts*, the taxpayers held an apartment complex that was encumbered by a non-recourse debt of \$1.85 million. The property had a fair market value of \$1.4 million, and an adjusted basis of \$1.45 million. The taxpayers transferred the property to a third party who assumed the non-recourse debt.<sup>80</sup> The Court in *Tufts* held that the taxpayers realized a gain from the sale or exchange of property of approximately \$400,000 (\$1.85 million amount realized, less \$1.45 million adjusted basis).<sup>81</sup> A cursory view of the *Tufts* holding could lead to the conclusion that the Supreme Court has rejected the possibility of characterizing that gain as cancellation of indebtedness income rather than as gain from the sale or exchange of property. The *Tufts* Court noted in footnote eleven, however, that such a characterization was possible, and would result in a capital loss of \$50,000 on the sale or exchange of property (\$1.45 million adjusted basis, less \$1.4 million fair market value), and in ordinary income in the amount of \$450,000 from the discharge of indebtedness (\$1.85 million debt canceled, less \$1.4 million fair market value).<sup>82</sup> The Court noted that such an analysis could be justifiable but specifically stated that it was "not presented with and [did] not decide the contours of the cancellation-of-indebtedness doctrine" since neither the taxpayer nor the Commissioner argued that such a characterization would be proper.<sup>83</sup> The Court did point out, however, that difficulty might arise in applying the cancellation of indebtedness concept to non-recourse debt cancellation since it is difficult to conceive of how assets are thereby freed.<sup>84</sup> The problem of considering non-recourse debt as the taxpayer's for purposes of gain on the disposition of property and not for purposes of discharge of indebtedness will be discussed later herein.<sup>85</sup>

Another problem in this area is the possible effect of I.R.C. sections 1245 and 1250<sup>86</sup> when property is transferred to cancel nonrecourse debt. In *Estate of Delman v. Commissioner*,<sup>87</sup> the Tax Court held, among other things, that when \$1.2 million of nonrecourse debt is cancelled in exchange for property having a fair market value of \$400,000 and an adjusted basis of

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78. See, e.g., *Commissioner v. Tufts*, 103 S. Ct. at n. 11; *Collins v. Commissioner*, 22 T.C.M. (CCH) at 1471; *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. at 521.

79. *Commissioner v. Tufts*, 103 S. Ct. 1826 (1983).

80. *Id.* at 1828-29.

81. *Id.* at 1836.

82. *Id.* at 1833 n. 11.

83. *Id.*

84. *Id.*

85. See *infra* text accompanying note 104.

86. I.R.C. §§ 1245, 1250 (1981). These sections provide for recapture as ordinary income of some depreciation previously taken when the depreciated property is disposed of. *Id.*

87. 73 T.C. 15 (1979).

\$500,000, there is no income from discharge of indebtedness and, thus, section 108, is not applicable.<sup>88</sup> The court also held that there was \$700,000 of gain realized under section 1001 that was to be characterized as ordinary income under section 1245, even though the fair market value of the property was less than its adjusted basis.<sup>89</sup> This, of course, is just an extreme example of the principle that has already been discussed, namely that cancellation of nonrecourse debt by property transfer results in gain from the disposition of property.<sup>90</sup>

The *Delman* court went one step further. At the end of its opinion, the court stated that even if there was discharge of indebtedness income and section 108 did apply, "section 1245 requires recognition of the income notwithstanding sections 108 and 1017."<sup>91</sup> This statement by the *Delman* court seems to be incorrect. Neither section 1245, nor section 1250 of the I.R.C. become effective unless property has been "disposed of."<sup>92</sup> Furthermore, sections 1245 and 1250 merely provide for the recognition<sup>93</sup> and characterization<sup>94</sup> of gain that has been realized under some other section, rather than create such gain.<sup>95</sup> Hence, in order for sections 1245 and 1250 to become operational, there must be some provision in effect that provides for realization of gain upon the disposal of property. The provision that sets forth the general rule for gain realization upon the disposal of property is section 1001.<sup>96</sup> Section 1001 must provide for realization of gain before sections 1245 and 1250 can affect the taxpayer. The *Delman* court indicated, however, that even if section 108 applies, section 1245 overrides<sup>97</sup> and requires recognition of ordinary income.<sup>98</sup> This cannot be true since the very fact that discharge of indebtedness income exists means that section 1001, regarding gain on dispositions of property, will not apply to that portion of income. This is because a preliminary determination must have been made that there was no "disposition" of the property within the meaning of sections 1001, 1245, and 1250 with respect to that portion of the amount received

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88. *Id.* at 27-28, 39.

89. *Id.* at 28, 29, 37.

90. *See supra* text accompanying notes 33-38.

91. *Estate of Delman v. Commissioner*, 73 T.C. at 40.

92. I.R.C. §§ 1245(a)(1), 1250(a)(1)(A) (1981).

93. Recognition and realization are distinct concepts. If gain has been realized, that merely means that there has been an accession to wealth that may at some time be taxed. If that realized gain must be recognized it will be currently taxed.

94. Generally, income that is to be recognized can be characterized as being either ordinary income, or capital gain. Sections 1245 and 1250 generally operate to transform capital gain into ordinary income.

95. I.R.C. §§ 1245(a)(1), 1250(a)(1)(A) (1981).

96. I.R.C. § 1001(a) (1976).

97. This means that section 1245 would apply to the transaction even if it was considered to be a disposition of property.

98. *Estate of Delman v. Commissioner*, 73 T.C. at 40.

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which was treated as discharge of indebtedness income.<sup>99</sup> The conclusion, then, is that if section 108 applies to an amount, section 1001 cannot apply by definition, hence, neither can sections 1245 and 1250.

The conclusion that there is a dichotomy between section 108 and sections 1001, 1245, and 1250 is consistent with the legislative history of section 108. Both the House and Senate reports reflect an intent to defer the recognition of discharge of indebtedness income under certain circumstances and to provide for *later* recapture of the excluded income under sections 1245 and 1250 when property is sold whose basis was reduced under section 108.<sup>100</sup> Therefore, if it can be shown that cancellation of a nonrecourse debt should result in discharge of indebtedness income, neither section 1245 nor 1250 should bar exclusion of that income under section 108.

In sum, the current weight of authority provides that debt cancellation by property transfer results in discharge of indebtedness income that is potentially excludable under section 108 only to the extent of the excess of the face amount of the debt cancelled over the fair market value of the property transferred by the debtor, and only if the obligation is recourse. If the obligation is nonrecourse, then the weight of authority is that there is never discharge of indebtedness income.

### III. THE PROPER INTERPRETATION OF DEBT CANCELLATION BY PROPERTY TRANSFER: *Dallas Transfer v. Commissioner*

The amount of debt cancellation that is considered to be gain under I.R.C. section 1001 when either recourse or nonrecourse debt is cancelled should be excludable under section 108. In other words, if a *recourse* debt with a face amount of \$100 is cancelled in exchange for property having a fair market value of \$75 and an adjusted basis of \$25, then the \$50 that would normally be gain<sup>101</sup> under section 1001 from the disposition of property should be potentially excludable under section 108. If the same transaction took place involving a *nonrecourse* debt, then the amount excludable would be \$75, which would be the section 1001 gain.<sup>102</sup> The effect of this rule would be to treat the section 1001 gain (\$50 or \$75) as "income by reason of the discharge . . . of indebtedness"<sup>103</sup> whether the debt was recourse or nonrecourse.<sup>104</sup> The relieved debtor would then have to meet the other require-

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99. The debt discharge must have been considered a "direct" source of payment rather than a medium for payment. See *supra* text accompanying notes 27-38.

100. See *supra* note 19.

101. See *supra* text accompanying notes 34-38.

102. See *supra* text accompanying notes 73-74.

103. I.R.C. § 108(a) (1981).

104. This treatment is in direct contradiction with the current policy of never treating *nonrecourse* debt cancellation as discharge of indebtedness income. See *supra* text accompanying notes 69-91. However, that should not bar adoption of the proposed rule.

First, it seems contradictory to treat the debt as being sufficiently that of the taxpayer for

ments of section 108 in order to exclude that amount from gross income.<sup>106</sup>

It should be noted that this proposed rule does not affect the tax treatment of the amount by which the face value of *recourse* debt exceeds the fair market value of the property transferred<sup>106</sup> under current law. The \$25 excess of debt cancelled over value transferred is already considered to be discharge of indebtedness income that is potentially excludable under section 108.<sup>107</sup>

Before the legal reasons for adopting this rule are developed, the factual basis for the rule should be analyzed. Suppose that the debtor in the example used earlier<sup>108</sup> is insolvent and the debt is either recourse or nonrecourse (it does not matter which). Under current law, if the debtor transfers the property to the creditor in complete satisfaction of the debt, then at least \$50 of gain must be immediately recognized.<sup>109</sup> If, instead, the debtor paid \$75 to the creditor and retained the property, then there would be no section 1001 gain to be immediately recognized and the debtor would retain the use of the property.<sup>110</sup> In addition, if the debtor did not have cash to pay the

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purposes of creating an amount realized for purposes of section 1001 and not for purposes of section 108. *See supra* text accompanying notes 69-91. For instance, in *Crane v. Commissioner of Internal Revenue*, 331 U.S. 1 (1947), the Court held that "the reality [is] that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations." *Id.* at 14. If the "reality" is that the taxpayer will treat the debt as his own, at least to the extent of the encumbered property's fair market value, then cancellation of that debt should be eligible for treatment as discharge of indebtedness income under the principle that income is determined by substance and not form. *See Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 174 (1926).

Second, section 108(d)(1), by its terms, applies to nonrecourse debt. Under section 108(d)(1), "indebtedness of the taxpayer" is defined as "any indebtedness—(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property." I.R.C. § 108(d)(1) (1981). The first part of the definition applies to *recourse* debt, and the second applies to *non-recourse* debt.

105. If the debtor could not meet the requirements of section 108, then, to be consistent, the resulting income should be discharge of indebtedness income and, hence, ordinary gain. This may be a disadvantage to relieved debtors who do not fall within section 108 because their gain would be section 1001 gain without this rule and may be capital gain under I.R.C. section 1222 or 1231. I.R.C. §§ 1222, 1231 (1981). However, even in that case the gain may be ordinary income under the recapture provisions. *See* I.R.C. §§ 1245, 1250 (1981). Of course debt cancellation by property transfer may be considered income from discharge of indebtedness only for purposes of section 108.

106. This is \$25 in the example. *See supra* text accompanying note 101.

107. *See supra* text accompanying notes 27-32.

108. *See supra* text accompanying notes 9-11.

109. The gain may be capital gain, unless there is depreciation recapture. *See* I.R.C. §§ 1221, 1222, 1231, 1245, 1250 (1981). It should also be noted that the former debtor cannot subsequently file bankruptcy to discharge the resulting tax liability because federal income taxes are not dischargeable in bankruptcy unless the return on which the tax was owing was due more than three years hence. *See* 11 U.S.C. §§ 523(a)(1), 507(a)(2), 507(a)(6), 502(f) (1981).

110. Since there is no disposal of the property, section 1001 does not apply. *See* I.R.C. § 1001(a) (1976); *Hirsch v. Commissioner*, 115 F. 2d 656, 657 (7th Cir. 1940); *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519, 520-21 (1934).

creditor he could refuse to do anything at all or attempt to elude the creditor in the hope that the creditor would write off the debt, in which case the debtor would also have no section 1001 gain under current law.<sup>111</sup> By doing this, however, he may have potentially excludable income from the discharge of indebtedness in the amount of \$100.<sup>112</sup> If the creditor attempted to enforce collection, the debtor could file bankruptcy and thereby recognize no immediate income<sup>113</sup> even if some property was disposed of under the bankruptcy.<sup>114</sup>

The strategy that an insolvent debtor takes in negotiating with his creditors can clearly have a tremendous impact on the debtor's tax liability. This disparate treatment seems unjustified. It makes little sense to immediately tax an insolvent taxpayer for gain when that person has lost the use of an asset and yet not tax an insolvent debtor for any current gain when he eliminates the debt either by cash settlement, elusiveness, or bankruptcy, and keeps the property (unless he loses the property under the bankruptcy option). Granted, if the debtor keeps the property, then the government may later tax any appreciation in the property upon disposal assuming that the property has not declined in value due to use or obsolescence.<sup>115</sup> However, that is not a good reason to currently tax the insolvent debtor who transfers his property; he should be able to *defer* recognition of gain under section 108 as well.

It is important to note that section 108 generally operates to *defer*, rather than to eliminate gain recognition.<sup>116</sup> Furthermore, if the taxpayer is using the insolvency provision of section 108, there are certain circumstances under which section 108 allows the debtor to avoid gain recognition altogether.<sup>117</sup> The prudence of that potential for complete gain avoidance is beyond the scope of this Note. The important point here is that taxpayers who transfer property to cancel a debt should be treated the same as those

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111. There is no disposal so section 1001 does not apply. See I.R.C. § 1001(a) (1976); *Hirsch v. Commissioner*, 115 F. 2d 656, 657 (7th Cir. 1940); *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519, 520-21 (1934).

112. See I.R.C. §§ 61(a)(12), 108 (1981).

113. No immediate income would be recognized from either section 1001 gain or from discharge of indebtedness income. See *infra* note 114.

114. See I.R.C. § 108 (1981); *Davis v. Commissioner*, 69 T.C. 2422, 2435-36 (1978). There is some question, however, whether section 108 excludes debt cancellation by property transfer as part of a bankruptcy proceeding if the bankruptcy estate is solvent after all of the debts are discharged.

115. See I.R.C. § 61(1976); Treas. Reg. § 1.61-6(a)(1957).

116. See I.R.C. § 108(b) (1981). See also *supra* note 19.

117. Under the insolvency provision of section 108, the taxpayer's ability to exclude debt cancellation income is not limited to his ability to reduce the enumerated tax attributes. See I.R.C. §§ 108(a), 108(b) (1981). See also *supra* note 19. Since reduction of the tax attributes is the method of later recapturing the gain excluded under section 108, the taxpayer may avoid later gain recognition if he does not have sufficient tax attributes to reduce by the same magnitude of his exclusion from gross income.

that achieve debt cancellation by cash settlement, elusiveness, or bankruptcy.

An excellent example of the inequity of the current treatment of debt cancellation by property transfer is provided by *Estate of Delman v. Commissioner*.<sup>118</sup> In *Delman*, the taxpayer satisfied \$1.2 million of nonrecourse debt by transferring property having a value of \$400,000 and an adjusted basis of \$500,000 to the creditor.<sup>119</sup> The debtor was insolvent before and after the repossession.<sup>120</sup> The *Delman* Court held that the debtor must recognize \$700,000 of ordinary income in the year of the transfer (\$1.2 million debt cancelled, less \$500,000 adjusted basis of property transferred).<sup>121</sup> Had the debtor sold the property and then paid \$400,000 to the creditor, he would have had a loss on the sale in the year of transfer and he would have had no income since the debt was nonrecourse.<sup>122</sup> Even if the debt had been recourse, the debtor would only have had \$800,000 of *excludable* income under section 108.<sup>123</sup> If the debtor had filed bankruptcy, he would have recognized no immediate gain.<sup>124</sup>

The same unequal treatment applies even if the debtor is solvent but seeks exclusion under the qualified business indebtedness provision of section 108.<sup>125</sup> In that situation, the debtor does not have the bankruptcy option but is still given different tax treatment depending on whether he transfers property to settle the debt, pays a cash settlement, or refuses to cooperate with the creditor until forced to do so.<sup>126</sup> The most equitable solution in this situation is to allow the debtor who cooperates with the creditor and transfers property to settle the debt to postpone income recognition.<sup>127</sup>

Given the current unequal treatment of the various means of achieving debt cancellation, sections 108 and 1001 operate to encourage bankruptcy,

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118. 73. T.C. 15 (1979).

119. *Id.* at 27-28.

120. *Id.*

121. *Id.* at 39.

122. See I.R.C. § 1001(a) (1976); *Collins v. Commissioner*, 22 T.C.M. (CCH) 1467, 1471 (1963).

123. See I.R.C. § 108 (1981).

124. *Id.*

125. See *supra* note 19.

126. See *supra* text accompanying notes 107-109.

127. I.R.C. § 108 operates merely to postpone gain. This is particularly true in the case of cancellation of qualified business indebtedness because section 108 allows an exclusion only to the extent that the taxpayer can reduce his basis in depreciable property. See I.R.C. § 108(c)(2) (1981). See *supra* note 19. If the basis of depreciable property is reduced, income will eventually be recognized in the form of lower depreciation deductions and higher gain on eventual disposition of the property which will be recaptured under section 1245 or 1250. I.R.C. § 1017(d) (1981); see *supra* note 19. If there is no depreciable property available for basis reduction, then no exclusion is available under section 108. See I.R.C. § 108(c)(2) (1981). Regardless of whether an individual agrees with the qualified business indebtedness provision of section 108, the point here is that a debtor who transfers property to cancel the debt should be treated equally with the debtor who transfers cash or refuses to cooperate with the creditor.

or at least, lack of cooperation by debtors. The reason for this effect is that the debtor has much to gain from a tax viewpoint by not cooperating, and by filing bankruptcy.<sup>128</sup> This is not a desirable objective since it hinders voluntary resolution of debtor-creditor problems and encourages the more expensive options of forced collection procedures or bankruptcy. Of course, section 108 as currently interpreted would not encourage bankruptcy or non-cooperation if neither lawyers nor debtors took into account its effect while structuring debt cancellation. However, in that event sections 108 and 1001 operate as a trap for the unwary since substantial amounts of unexpected gain may result.

The current treatment of debt cancellation by property transfer can also be criticized for its failure to reflect economic reality. In her concurrence in *Tufts*, Justice O'Connor stated that the amount realized on the exchange of property in cancellation of a non-recourse debt should be limited to the fair market value of the property since the mortgagee cannot expect to collect more than that amount on the debt.<sup>129</sup> Justice O'Connor went on to note that if the face value of the non-recourse debt cancelled exceeds the fair market value of the property, then that difference should be characterized as cancellation of indebtedness income that is potentially eligible for exclusion under I.R.C. section 108.<sup>130</sup>

Even though neither the courts nor the regulations seem to recognize the cogency of these arguments,<sup>131</sup> Congress apparently did in drafting section 108 because current interpretations of section 108 seem to conflict with its legislative history.<sup>132</sup>

Congress amended section 108 as part of the I.R.C. reorganization of 1954.<sup>133</sup> The House of Representatives' version of section 108 included a provision that specifically excluded debt cancellation by property transfer from the application of the section.<sup>134</sup> The Senate deleted that provision because it was "connected with section 76 which [was] removed from the bill."<sup>135</sup> The Conference Committee then accepted the Senate deletion of the restriction on section 108.<sup>136</sup> On its face, the legislative history seems to indicate that section 108 was intended to apply to debt cancellation by property

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128. See *supra* note 114 and accompanying text.

129. *Commissioner v. Tufts*, 103 S. Ct. at 1837 (O'Connor, J., concurring).

130. *Id.* Justice O'Connor concurred with the majority despite this interpretation because she found that the Commissioner's view, although contrary to hers, was not unreasonable or arbitrary. *Id.*

131. See, e.g., Treas. Reg. §§ 1.1001-2(c) example 7, 1.1001-2(c) example 8 (1980); *Estate of Delman v. Commissioner*, 73 T.C. 15, 39 (1979).

132. See *supra* text accompanying notes 23-38, 69-75.

133. See *infra* notes 134-36 and accompanying text.

134. H.R. REP. NO. 1337, 83d Cong., 2d Sess. A35 (1954).

135. S. REP. NO. 1622, 83d Cong., 2d Sess. 186 (1954).

136. H.R. REP. NO. 2543, 83d Cong., 2d Sess. 1 (1954).

transfer. However, the Tax Court in *Estate of Delman v. Commissioner*<sup>137</sup> rejected that hypothesis by stressing that the Senate linked the deletion to the elimination of section 76.<sup>138</sup> The *Delman* Court noted that section 76 defined discharge of indebtedness income.<sup>139</sup> In eliminating that section, the Conference Committee Report indicates that the determination of what constitutes income from debt cancellation is to be made "by applying the general rules for determining gross income."<sup>140</sup> Basing its decision on this legislative history, the *Delman* Court held that section 108 does not apply to debt cancellation by the transfer of property.<sup>141</sup>

Contrary to the holding in *Delman*, it is arguable that the 1954 Congress intended section 108 to apply to debt discharged by property transfer since it eliminated a specific proposal for section 108 to not apply to such a transaction. Furthermore, a question still remains as to what "general rules for determining gross income" the 1954 Congress had in mind with regard to property transfers. None of the legislative materials relevant to the 1954 Code answer this question.

While enacting the 1980 amendments to section 108, Congress did provide some indication that section 108 is intended to apply to debt cancellation by property transfer.<sup>142</sup> In both the House and Senate reports regarding the Bankruptcy Tax Act of 1980, *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*<sup>143</sup> was cited as indicating what the current exceptions were to recognizing discharge of indebtedness income.<sup>144</sup> From this we can infer that *Dallas Transfer* is an important case in the area of discharge of indebtedness income.

In *Dallas Transfer*, the Fifth Circuit was faced with a situation in which an insolvent debtor cancelled recourse debt in the amount of \$107,000 by transferring to the creditor property which had a fair market value of \$42,000 (less a \$25,000 mortgage on the property) and an adjusted basis of \$39,000.<sup>145</sup> Under current interpretations of section 108,<sup>146</sup> there would be at least \$3,000 (\$42,000 value, less \$39,000 adjusted basis) of gain that would not be excludable under section 108 because it would be interpreted as sec-

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137. 73 T.C. 15 (1979).

138. *Id.* at 39-40 n. 19.

139. *Id.*

140. H.R. REP. No. 2543, 83d Cong., 2d Sess. 23 (1954). *See also* *Estate of Delman v. Commissioner*, 73 T.C. at 39-40 n. 19.

141. *Estate of Delman v. Commissioner*, 73 T.C. at 39-40 n. 19.

142. *See* H.R. REP. No. 833, 96th Cong., 2d Sess. 7 & n. 1 (1980); S. REP. No. 1035, 96th Cong., 2d Sess. 7 & n. 1 (1980).

143. 70 F.2d 95 (5th Cir. 1934).

144. *See supra* note 110.

145. *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d at 95.

146. *See, e.g., Spartan Petroleum Co. v. United States*, 437 F. Supp. 733, 736-37 (D.S.C. 1977); *Delman*, 73 T.C. at 39.

tion 1001 gain, rather than as discharge of indebtedness income.<sup>147</sup> However, the *Dallas Transfer* court held that the entire amount of \$68,000 (\$107,000 less \$39,000 adjusted basis) was discharge of indebtedness income that was excluded from gross income under the common law insolvency exception.<sup>148</sup>

Although the common law insolvency exception no longer exists,<sup>149</sup> the critical finding by the *Dallas Transfer* court is that debt cancellation by property transfer is *categorized* as discharge of indebtedness income.<sup>150</sup> Most importantly, this finding takes on the weight of legislative history since both the House and Senate reports regarding the 1980 amendments to section 108 cite to *Dallas Transfer*.<sup>151</sup> Furthermore, some cases have followed the *Dallas Transfer* approach,<sup>152</sup> even though it is not the current state of the law.<sup>153</sup> In summary, logic and good policy indicate that section 108 should apply to debt cancellation by property transfer in the same manner as it applies to debt cancellation without consideration, debt cancellation by cash settlement, and debt cancellation due to bankruptcy.

#### IV. PROPOSED CHANGES

There are several means by which current interpretations of section 108 can be changed to allow application to property transfers in cancellation of debt. First, the judiciary may be persuaded to adopt this change. Since both the Tax Court<sup>154</sup> and at least one District Court<sup>155</sup> have recently ruled that section 108 does not apply to such debt discharge, it may be wise to bring such a case in the Court of Claims. However, the biggest problem with this approach is that examples seven and eight of Treasury Regulation section 1.1001-2(c) are directly on point and categorize income from debt cancellation by property transfer as section 1001 gain at least to the extent of the

147. See *supra* text accompanying notes 34-38.

148. *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d at 96. Basically, the insolvency exception prevented the recognition of gross income by the debtor when debt was cancelled and the debtor was insolvent before the cancellation. *Id.* Some cases did provide for income recognition to the extent of solvency after the discharge. See, e.g., *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289, 292 (1937).

149. See I.R.C. § 108(e)(1) (1981).

150. *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d at 96.

151. See H. R. REP. No. 833, 96th Cong., 2d Sess. 7 & n. 1 (1980); S. REP. No. 1035, 96th Cong., 2d Sess. 8 & n. 1 (1980).

152. See, e.g., *Brutsche v. Commissioner*, 65 T.C. 1034, 1063 (1965); *Texas Gas Distrib. Co. v. Commissioner*, 3 T.C. 57, 61 (1944). In *Texas Gas*, the court cited to *Dallas Transfer* and held that "[w]here an insolvent debtor turns over all or part of his property to his creditors in full or partial satisfaction of his debts, if the debtor remains insolvent he realizes no taxable gain." *Id.*

153. See *Spartan Petroleum Co. v. United States*, 437 F. Supp. at 736-37; *Estate of Delman v. Commissioner*, 73 T.C. at 39.

154. *Estate of Delman v. Commissioner*, 73 T.C. 15, 39.

155. *Spartan Petroleum Co. v. United States*, 437 F. Supp. 733.

value of the property transferred, less its adjusted basis.<sup>156</sup> If this treasury regulation were to be given the force of law, courts would be unable to judicially apply section 108 to debt discharge by property transfer. These regulations are not, however, specifically authorized by the section to which they apply,<sup>157</sup> so they are merely interpretative regulations.<sup>158</sup>

Interpretative regulations are generally given the force of law by the courts based on one of three theories:<sup>159</sup> contemporaneous construction,<sup>160</sup> long-continued administrative practice,<sup>161</sup> and legislative reenactment.<sup>162</sup> The contemporaneous construction theory should not lend force to the regulations in this instance. The critical language of section 108 here is its reference to income from the discharge of indebtedness. That language has been in section 108 since it was first enacted in 1954.<sup>163</sup> In contrast, Treasury Regulation section 1.1001-2 was published on December 12, 1980.<sup>164</sup> Hence, the regulations were not promulgated contemporaneously with the I.R.C. section which they interpret.

The regulations also should not be given great weight by the courts under the "long continued administrative practice" theory. The cases that espouse this theory generally refer to regulations that have been in existence for a long period of time.<sup>165</sup> Since the regulations were promulgated late in 1980, they have not been outstanding for a substantial time.

Finally, the legislative reenactment theory also should not provide validity to the regulations. The regulations were promulgated *after* the latest amendment to section 1001.<sup>166</sup> Hence, any argument for the validity of the

156. Treas. Reg. §§ 1.1001-2(c) example 7, 1.1001-2(c) example 8 (1980).

157. See I.R.C. § 1001 (1976).

158. See Rogovin, *The Four R's: Regulations, Rulings, Reliance and Retroactivity*, 43 TAXES 756, 758-59 (1965). Interpretative regulations are authorized under I.R.C. § 7805(a) (1976).

159. See Rogovin, *supra* note 158, at 759.

160. This doctrine states that "[r]egulations issued contemporaneously with the enactment of a statute will be presumed to represent the general understanding of the meaning of the statute." *Id.* at 760. See *Commissioner v. South Tex. Lumber Co.*, 333 U.S. 496, 501 (1948).

161. This theory dictates that "[r]egulations expressing a long-continued administrative practice are entitled to respectful consideration." Rogovin, *supra* note 158, at 760. See *Helvering v. Winmill*, 305 U.S. 79, 83 (1938).

162. The theory behind this doctrine is "that Congress is aware of the Treasury's interpretative regulations and is tacitly approving the Commissioner's interpretation, when it reenacts a statute without change." Rogovin, *supra* note 158, at 760. See *Lykes v. United States*, 343 U.S. 118, 127 (1952); *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110, 115 (1939).

163. I.R.C. § 108 (1954).

164. T.D. 7741, 1981-1 C.B. 430, 433.

165. See, e.g., *Helvering v. Winmill*, 305 U.S. 79, 83 (1938) (regulations were given validity based on twenty-two years of existence without legislative repeal).

166. The last time I.R.C. section 1001 was amended was 1979 by P.L. 96-223. H.R. 3919, 95th Cong., 2d Sess. (1980). All amendments to I.R.C. § 1001 only relate to carryover basis from decedents. See *id.*, H.R. 13511, 95th Cong., 2d Sess. (1978); H. R. 13270, 91st Cong., 1st Sess. (1969). Furthermore, even if amendments to section 108 could be construed as reenacting Regu-

regulations must be based solely on the fact that the Economic Recovery Tax Act<sup>167</sup> and the Tax Equity and Fiscal Responsibility Act<sup>168</sup> were enacted after the regulations were published. This is not as strong a basis for validity as the situation in which Congress specifically addresses the pertinent section by amendment without altering the interpretation of the regulations. Furthermore, two reenactments of the I.R.C. in general are not evidence of a consistent line of congressional approval.<sup>169</sup>

Even though the regulations in question were recently enacted and do not bear the indicia required to be given the force of law, they still will not be invalidated by the courts unless they are shown to be contrary to the statute, or unreasonable.<sup>170</sup> Unfortunately, the United States Supreme Court held in *Tufts* that there is nothing "to indicate that the Code requires the Commissioner to adopt" the view that cancellation of a non-recourse debt by property transfer results in discharge of indebtedness income, rather than gains from the sale or exchange of property.<sup>171</sup> Furthermore, Justice O'Connor noted in her concurrence that the Commissioner was reasonable in characterizing non-recourse debt cancellation by property transfer as resulting in gain from the sale or exchange of property.<sup>172</sup> Nevertheless, the *Tufts* ruling should not be considered to be engraved in stone. The *Tufts* Court did acknowledge that it was not presented with the question of the propriety of cancellation of indebtedness treatment.<sup>173</sup> If the Court is fully briefed on that issue, it may be persuaded to conclude that debt cancellation by property transfer should fall within the terms of section 108, and that the regulations under section 1001 are therefore invalid.

In this regard, a taxpayer must argue that the legislative history of section 108 indicates that debt cancellation by property transfer should fall within its provisions. Therefore, Treasury Regulation section 1.1001-2 should not bar that result merely by categorizing such income as section 1001 gain. In an analogous situation the Supreme Court, in *M.E. Blatt Co. v.*

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lation section 1.1001-2, the terms of the last amendment to section 108 were finalized before Regulation section 1.1001-2. The House report regarding section 108 was issued on March 19, 1980. H.R. REP. NO. 833, 96th Cong., 2d Sess. 1 (1980). Although the Senate report was issued on December 13, 1980 (one day after the regulations were published, *see supra* note 164 and accompanying text), its contents mirror the House report which was prepared much earlier. S. REP. NO. 1035, 96th Cong., 2d Sess. 1 (1980).

167. H.R. REP. NO. 4242, 97th Cong., 1st Sess. (1981).

168. H.R. REP. NO. 4961, 97th Cong., 2d Sess. (1982).

169. In *Lykes*, the I.R.C. had been amended three times over a period of three years since the regulations were promulgated. *Lykes v. United States*, 343 U.S. at 127. Furthermore, the regulations had been in effect for six years at the time of the decision. *Id.* In *R.J. Reynolds*, the section in question had been reenacted eight times over a period of thirty years since the regulations had been written. *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. at 115.

170. Rogovin, *supra* note 158, at 759.

171. *Commissioner v. Tufts*, 103 S. Ct. at 1833 n.11.

172. *Id.* at 1838 (O'Connor, J., concurring).

173. *Id.* at 1833 n. 11.

*United States*,<sup>174</sup> held that lessee improvements are not income to the lessor.<sup>175</sup> The Court did so even though the applicable regulations treated such amounts as income.<sup>176</sup> The Court held that “[t]reasury [r]egulations can add nothing to income as defined by Congress.”<sup>177</sup>

Another method of changing the current interpretation of sections 108 and 1001 is for the Treasury Department to amend its regulations under those sections. No regulations have yet been promulgated under section 108 since that section was significantly amended in 1980.<sup>178</sup> When the Treasury Department issues new regulations under section 108, it should indicate specifically that debt cancellation by property transfer creates discharge of indebtedness income that is potentially excludable under section 108, even to the extent of the difference between the value of the property transferred and its adjusted basis, and regardless of whether the debt cancelled is recourse or nonrecourse. There should also be a concomitant amendment of Regulation section 1.1001-2.<sup>179</sup>

If neither the courts nor the Treasury Department decides to change their position, Congress should act by specifically amending I.R.C. section 108. A new subparagraph should be added: Section 108(d)(6). The new subparagraph would then be under the portion of section 108 which provides the meanings of terms.<sup>180</sup> Section 108(d)(6) should contain a provision similar to the following:

Discharge of Indebtedness—The term “discharge of indebtedness” has the same meaning as when used in section 61(a)(12) and the regulations thereunder. The term shall, however, include all gain realized by the taxpayer upon cancellation of recourse or nonrecourse indebtedness of the taxpayer in consideration for the transfer of property by the taxpayer.

## V. CONCLUSION

Sections 108 and 1001 now create a situation in which lawyers can easily fail to adequately protect their clients who are debtors. Under current law, an attorney should advise his client of the potential consequences of placating a creditor by giving him a security interest in the debtor’s property: if

174. 305 U.S. 267 (1938).

175. *Id.* at 279.

176. *Id.*

177. *Id.*

178. See Treas. Reg. §§ 1.108(a)-1, -2, (b)-1 (1956).

179. The following provisions of Treas. Reg. § 1.1001-2 (1980) would have to be amended: (1) Sections 1.1001-2(a)(2), 1.1001-2(a)(4)(i), 1.1001-2(a)(4)(ii), 1.1001-2(a)(4)(iii), and 1.1001-2(b) would be unnecessary if debt cancellation by property transfer is considered entirely as income from the discharge of indebtedness for all purposes. (2) Section 1.1001-2(c), examples 7 and 8, should be amended to reflect no gain from the disposal of property, and to show all gain as discharge of indebtedness income.

180. See I.R.C. § 108(d) (1981).

the debtor later defaults, he may be forced to immediately recognize large amounts of gain if the creditor decides to foreclose on his security. Also, attorneys should take into account the tax advantages of bankruptcy or cash settlement under current law when advising their clients regarding their options if they are in financial difficulty. Finally, if a client is forced to transfer property to his creditors, then a consent to reduce basis should be filed with the client's income tax return for the taxable year in which the discharge occurs in order to preserve a claim that section 108 should apply.<sup>181</sup>

These problems are caused by the fact that current interpretations of sections 108 and 1001 treat debtors unequally when, in fact, debtors who transfer property to their creditors to cancel debt should be treated the same as debtors who achieve debt cancellation by other means such as cash settlement, elusiveness, or bankruptcy. This inequitable treatment should be remedied by either judicial reconsideration, regulation amendment, or statutory amendment.

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181. See Temporary Treas. Reg. § 7a.1 (1981). If the debtor seeks 108 exclusion based on the qualified business indebtedness provision, then he must file a timely consent to reduce the basis of his remaining depreciable property. *Id.* If he seeks exclusion under the bankruptcy or insolvency provisions, then no election needs to be filed, unless the debtor wants to elect to reduce the basis of his remaining property (depreciable and nondepreciable) before the other tax attributes are reduced. *Id.* Nevertheless, the insolvent debtor should still consider filing a *conditional* consent to reduce basis so that if he is determined to not be insolvent both before and after the discharge, then he can still fall back on the qualified business indebtedness provision. For a general summary of the section 108 provisions just referred to, see *supra* note 19.