

Deborah H. Schenk, Marilynn and Ronald Grossman Professor of Taxation, NYU School of Law, *The Story of Kirby Lumber, the Many Faces of Discharge of Indebtedness Income*.

This chapter presents the story of *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), one of the shortest Supreme Court opinions ever to pack such a wallop. Drawing upon the parties' briefs, judicial opinions in cancellation of indebtedness cases, and scholarly commentary, it describes what was really involved in the case, the government's and the taxpayer's litigation strategies, the decisionmaking processes of the courts, and the case's impact on the development of the tax law.

The situation that gives rise to the *Kirby Lumber* issue can be stated very simply. Suppose *Lender* lends *Borrower* \$10,000 and some time later because B is unable to repay the full amount of the loan, L agrees to accept \$3,000 in satisfaction of the loan. *Kirby Lumber* holds that B has \$7,000 of income. But what if B had taken the \$10,000 and lost it all in his business or in gambling so that he did not make any money in the transaction? Or what if at the time L discharged the loan, B was insolvent or had declared bankruptcy? What if L was B's mother who lent the \$10,000 to help B pay medical school tuition and on graduation day forgave the loan? What if L had lent B the \$10,000 as the sales price of a used car, which turns out to be a lemon, and L accepts \$3,000 as payment for the car? The resolution of these cases turns in large part on why the borrower in the simple case has \$7,000 of income. For that we start with *Kirby Lumber*.

In 1931, in a two-paragraph opinion by Justice Holmes, the Supreme Court held that a discharge of indebtedness constituted gross income. The brevity of the opinion, a confusing reference to an earlier case, a failure to mention earlier cases that might be precedent, and extremely cryptic reasoning led to decades of confusion about the justification for the court's decision and its parameters.

For a long time, courts and commentators seized on the "freeing-up-of-assets" language in the court's opinion and crafted a theory that resulted in the borrower having income when the discharge freed up his assets, so-called cancellation of indebtedness or COD income. This theory would explain an early exception to the COD rule—an insolvent borrower has no income upon discharge so long as she remains insolvent. But this theory fails to explain the entire history of the rule—it is both too broad and too narrow. The whole transactions theory, explicated in *Bowers v. Kerbaugh-Empire*, 271 U.S. 170 (1926), a case cited favorably by the *Kirby* court, similarly fails. The notion that the taxpayer has no income on the discharge if the whole transaction is a loss is completely impractical and flies in the face of annual accounting. Neither of these two theories is acceptable and, in fact, they could produce entirely different results. Suppose B borrows \$100,000 from L and uses it to drill an oil well. B hits a dry hole and loses the entire \$100,000 investment. Although B is solvent, L discharges \$40,000 of the debt. Under the whole transaction theory, B would have no income because "the transaction as a whole was a loss." Under the freeing-of assets theory, B would have income of \$40,000 because the discharge "made available (\$40,000) assets previously offset" by the liability.

The conflict between the two theories apparently did not bother Justice Holmes, but they both cannot be right.

The chapter suggests that the “loan proceeds theory” is a much more satisfactory explanation of the taxation of COD income. Since the loan proceeds were excluded upon receipt, a failure to repay should result in taxable income. The taxpayer has received a financial benefit from the use of the borrowed funds, a financial benefit whose cost was less than the benefit. Although some courts have hinted that this approach makes much more sense, there is no general judicial or statutory consensus that the loan proceeds theory is the proper explanation for COD income.

On the face of it, *Kirby Lumber* appeared to apply very broadly. With the possible exception of the fact pattern in *Kerbaugh-Empire*, which the Court distinguished, there is nothing in the opinion that suggests that a debtor would not have COD income in all cases in which a debt was discharged in whole or in part. In order to provide relief from the harshness of the *Kirby Lumber* rule, over time the courts grafted on a number of exceptions. The confused reasoning in *Kirby Lumber* permitted the courts to use either the freeing-of-assets theory or the whole transaction theory to exempt certain transactions. Some of these exceptions were later codified, but some remain judicially created. Some of these exceptions, such as those that apply when bonds are issued as dividends or when stock or debt is swapped for debt are extremely important. The range of the exceptions is quite broad and illustrates how broadly *Kirby Lumber* and its many descendants have affected commercial practice.

The confusion engendered by *Kirby Lumber* and its progeny came home to roost sixty years later in *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990), a wonderfully wacky case that engendered four separate opinions in the Tax Court and two opinions in the Third Circuit, all based on different theories that revealed that the *Kirby Lumber* rule was still unclear. *Zarin* was a major Atlantic city real estate developer who played high-stakes craps on credit. He ran up \$3.5 million in debt before the casino pulled the plug. He ultimately settled for \$500,000. Whether he had \$3 million of COD income was the issue before the court. *Zarin* is a favorite case of law school tax professors—the facts are better than any hypothetical—because it manages to raise almost any possible theory one could imagine about the proper treatment of COD income, as well as several judicial and statutory exceptions. *Zarin*’s journey from Atlantic City to the Third Circuit is like a soap opera. *Zarin* is addicted to gambling; the casino is addicted to his presence, He fires and then sues his lawyers. He was indicted for theft by deception. But ultimately, he managed to gamble away \$3 million dollars without paying a penny for it and without any tax consequences, and for reasons that remain illusive.

Zarin illustrates that the courts are still unclear about the conceptual underpinning of the cancellation of indebtedness doctrine and its many exceptions. Sixty years later, we are still trying to figure out just what the court meant in the two-paragraph opinion in *Kirby Lumber*.

