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Avoiding Cancellation of Debt Income Where the Liability Is Disputed

A recent decision has revived the contested liability doctrine and provides support for debtors asserting offsets or counterclaims.

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The disputed liability doctrine (also known as the contested liability doctrine) is a judicially developed exception to cancellation of debt (COD) income. The Supreme Court, in *Kirby Lumber Co.,* 284 U.S. 1 (1931), held that upon forgiveness of its debts, a debtor has COD income attributable to the economic gain realized from the "freeing of its assets" from debt.[1] In *Kirby Lumber,* the taxpayer issued bonds at par and later that same year repurchased the bonds at a discount—a straightforward set of facts leading to the Court's logical conclusion. Whether COD income is realized, however, becomes more complex where, for example, the consideration received is less easily valued, or the taxpayer's liability is less clear.

Disputed Liability Doctrine

The seminal disputed liability case is *N. Sobel, Inc.,* 40 BTA 1263 (1939). There, a bank, in a campaign to sell its stock in 1929, sold shares to the taxpayer (its customer) and took back the taxpayer's note for $21,700. In November 1930, the taxpayer sued for rescission of the entire transaction, alleging that the loan violated state law and that the bank had breached certain promises it made under the purchase contract. The following month, the bank was closed because of insolvency. In accordance with a settlement in 1935, the taxpayer paid half the note and claimed a worthless stock loss for that amount. The Service argued that a worthless stock deduction for the full $21,700 should have been claimed in an earlier year. In addition, the Service contended that the taxpayer had COD income for the half of the note forgiven in the settlement.

The board found that there were questions as to whether the taxpayer bought the stock in 1929 and what, if anything, its liability was. These questions were not decided until the settlement of the suit, which fixed the liability at $10,850. Accordingly, the payment was properly deducted in 1935. Furthermore, there was no COD income. *Kirby Lumber* did not apply because "the release of the note was not the occasion for a freeing of assets and...there was no gain...."

Expansion of doctrine. The disputed liability doctrine has existed for many years, but has not received a great deal of attention—at least not until *Zarin,* 916 F.2d 110 (CA-3, 1990), *rev'g* 92 TC 1084 (1989), which appears to greatly expand its potential application.

Zarin was a "high roller" at the casinos in Atlantic City. From June 1978 to December 1979, Zarin lost $2.5 million at the craps tables of Resorts International Hotel. These losses were paid in full. In late 1979, New Jersey gambling authorities issued an order effectively prohibiting extensions of credit by Resorts to compulsive gamblers such as Zarin.[2] Resorts illegally continued to extend credit to Zarin until he had lost an additional $3.4 million in 1980. Checks Zarin wrote to cover the loss were returned for insufficient funds.

Zarin said he was willing to pay the amounts due to Resorts, but never did so. Resorts sued and Zarin denied liability on the grounds that Resort's claim was unenforceable under New Jersey law. In 1981, Zarin paid $500,000 to settle the claim.

On audit of Zarin's returns, the IRS asserted a deficiency for 1981, arguing that Zarin had $2.9 million of COD income (the original $3.4 million "debt" less the $500,000 settlement). The Tax Court agreed.

The appellate court's opinion. The Third Circuit stated that while the Service's logic was initially persuasive, it was nonetheless flawed. The court held that Zarin did not have COD income, basing its finding on a two-pronged analysis.

No liability—no debt. The court found that Sections 108 and 61(a)(12) were inapplicable. To come within the COD rules the taxpayer first must have, as required under Section 108(d)(1), a valid indebtedness "for which the taxpayer is liable, or ...subject to which the taxpayer holds property." Since Zarin's debt to Resorts was not legally enforceable, it clearly was not a debt "for which the taxpayer is liable." In addition, the court determined that Zarin did not have a debt subject to which he

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held property. Casino chips were merely an accounting mechanism to evidence debt and not property as contemplated by Section 108(d)(1). The court noted that New Jersey regarded gaming chips "solely as evidence of debt owed to their custodian by the casino licensee and...at no time [were] property of anyone other than the casino licensee issuing them."

Contested liability. Finding that the transaction was not the cancellation of a valid debt, the Third Circuit instead viewed it as a disputed debt to which the contested liability doctrine applied. The court stated that under the contested liability doctrine, if a taxpayer, in good faith, disputes a debt, a subsequent settlement for a lesser sum would be the amount of the debt for tax purposes. The excess of the original debt over the settlement amount is disregarded. The court illustrated this doctrine as follows (hereinafter referred to as the $10,000 Example):

EXAMPLE: Taxpayer borrowed $10,000 and then, in good faith, refused to repay it. Subject to a subsequent agreement with the lender, taxpayer repaid $7,000 in full satisfaction of the debt. The original loan is deemed to be $7,000 and, accordingly, there are no tax consequences to the taxpayer upon repayment.

In support of its decision, the Third Circuit cited *Sobel* and *Hall*, 307 F.2d 238 (CA-10, 1962), a case strikingly similar in its facts to *Zarin*. In *Hall*, the taxpayer owed a gambling debt of $225,000, which was unenforceable under state law. The casino sued the taxpayer, who agreed to pay $150,000. In full satisfaction of the agreement, the taxpayer delivered title to a herd of cattle that the district court found to be worth $148,110. The taxpayer thus was found to have COD income of $1,890, the difference between the settlement agreement and the value of the cattle. The Government appealed, arguing that the COD income should be measured from the $225,000 gambling debt satisfied rather than the $150,000 settlement agreement. The Tenth Circuit held that there was no COD income whatsoever in *Hall*. The liability was not fixed, according to the court, until the transfer of property settled the debt.

Analysis of the *Zarin* Opinion

To reach its conclusion, the Third Circuit took some unusual turns and hit some bumpy roads. Practitioners and the Service may find the court's analysis difficult to follow. Indeed, if the contested liability doctrine announced by the court is as absolute as it set forth the $10,000 Example, much of the court's analysis may be wasted dicta.

The court, while firmly basing its opinion on the contested liability doctrine, found that Zarin's debt was not legally valid and was "clearly not a debt for which the taxpayer is liable." The court also determined that despite the unenforceability of the debt, the debt nevertheless was "disputed" since it was worth something, namely $500,000. The court's characterization of the debt as "disputed" apparently was necessary to overcome the Service's assertion (which was accepted by the Tax Court) that the disputed liability doctrine cannot apply to a liquidated debt. In short, the Third Circuit determined that if a debt is unenforceable, in whole or in part, it is not liquidated.

In a more typical fact pattern, a debtor may have one or more good faith disputes allowing renegotiation of the principal of an otherwise valid indebtedness. The good faith disputes may not be apparent at the time the debt is created. For example, a later-discovered defect in property purchased subject to seller financing may make all or a part of the debt unenforceable because of a counter claim or right of offset. The concept of disputed liability is significant, however, only to the extent that the facts fall outside Section 108(e)(5), which provides relief from COD income for reduction in purchase-money debt between an original seller and purchaser.[3]

The appellate court performed substantial legal gymnastics to find that the chips received by Zarin were not "property."[4] Such a strained finding should not be necessary to invoke the disputed liability doctrine. In *Sobel*, relied upon by the court, there was no question that the stock received was property.[5] While a finding that property was received subject to a debt is important in determining whether Section 108 applies,

[1] This theory, of course, has since been codified (currently Section 61(a)(12)). Section 108 provides several *statutory* exceptions to COD income, e.g., discharges in bankruptcy or insolvency, and purchase-money debt reduction. See also Hart, "Debt Restructurings May Carry Increased Tax Costs Under RRA '90," 74 JTAX 16 (January 1991).

[2] See Resorts Int'l Hotel, Inc. v. Salomone, 429 A.2d 1078 (N.J., 1981), and Nemtin v. Zarin, 577 F. Supp. 1135 (DC N.J., 1983), for additional discussion of the New Jersey gambling laws and the conduct of the parties in the tax case. In Nemtin, Zarin's former girlfriend unsuccessfully sued to recover some of the more than $13 million she had advanced to him in 1978-1980. There is no evidence in the record of any IRS attempt to tax Zarin on COD income in those circumstances.

[3] Another issue is whether Section 108(e)(5) supersedes all other judicial exceptions recognized prior to the Bankruptcy Tax Act of 1980. Section 108(e)(5) is discussed further in the text below. See also Weindruch and Brown, "Scope of Purchase Price Exception to COD Income Questioned in New Ruling," page 302, this issue.

[4] The Tax Court also struggled with this issue, resolving that the gambling chips were not "normal commercial property" for which the taxpayer would be entitled to the benefits of Section 108(e)(5). A dissent presented a persuasive case for finding that the chips were property, not only as that term is used in general tax law, but also specifically for Section 108(e)(5).

[5] In N. Sobel, Inc., 40 BTA 1263 (1939), the question was whether the taxpayer purchased stock in an earlier year or whether, because of the dispute regarding the seller's actions, any transaction occurred prior to settlement in a later year. In Zarin, 916 F.2d 110 (CA-3, 1990), *rev'g* 92 TC 1084 (1989), the Third Circuit might have avoided the argument over whether chips were property by focusing on whether the chips were *purchased*.

[6] This example could be expanded to include an initially satisfied customer who expresses his willingness to pay the full fee and later, upon discovering a defect, demands a reduction. The Tax Court made much of the fact that Zarin intended to repay the debt to Resorts. That subjective intent should be ignored in light of Zarin's later action in disputing the debt, presumably after discovering the debt was unenforceable.

[7] Zarin, in his brief, succinctly described the reasoning of the Tax Court majority as "any casino patron who incurs paper gambling losses that he has no obligation to pay and does not pay, in the ordinary case, will be deemed to recognize federal taxable *income* in the amount of his losses."

it does not appear significant in determining whether the disputed liability doctrine applies. Section 108(a)(1) provides exceptions to COD income for discharges of indebtedness of the taxpayer in bankruptcy and insolvency. "Indebtedness of the taxpayer" is defined in Section 108(d)(1) as debt for which the taxpayer is liable or subject to which the taxpayer holds property. The judicially created disputed liability doctrine, however, is not in Section 108 or in any other provision of the Code. Given *Sobel*, it is unlikely that a finding that a taxpayer received property subject to a disputed debt would cause Section 108 to preempt the disputed liability doctrine. Other than the insolvency exception (which, as provided in Section 108(e)(1), clearly is exclusive), it appears that Section 108 merely provides some narrow statutory safe harbors for what otherwise would be COD income under Section 61(a)(12). The disputed liability doctrine should focus on the indebtedness created, not on the property received. The unusual nature of the property received in *Zarin* was certainly a significant factor in determining whether there was a bona fide disputed liability. There are, however, many fact patterns involving normal commercial property that should trigger the disputed liability doctrine.

Notwithstanding the sometimes confusing and overstated conclusion of the Third Circuit in *Zarin*, it is welcome relief from the position of the Tax Court. Under a logical extension of the Tax Court's rationale, any time a taxpayer negotiated a reduction in an invoice for other than a purchase of property, it would face the prospect of COD income. For example, an attorney or accountant writing down a billed invoice for a client could be creating COD income. The customer with a legitimate dispute who refuses to pay and successfully negotiates a decrease in a billed invoice, however, certainly should not be taxable on the reduction.[6]

Unfortunately, the Third Circuit sweeps back with the same broad brush in its reversal. The $10,000 Example is particularly hard to accept. A taxpayer who borrows $10,000 and has merely a technical defense to repayment (perhaps because of the running of the statute of limitations, the release of a guarantor, or some other improper lender action) and who settles in full for $7,000 should not escape taxation of the $3,000 increase in net worth. Logically, a dispute has to be more substantial than any offset or subsequent defense, even one that has legal merit and is presented in good faith, to trigger the disputed liability doctrine.

Future of the Contested Liability Doctrine

In the future, taxpayers who attempt to apply the disputed liability doctrine as espoused by *Zarin* will have to overcome the argument that the holding is unique to the facts of that case. The Service certainly will try to repudiate *Zarin* as an example of the old adage that "bad facts make bad law."[7]

Because of the potential breadth of the holding in *Zarin,* other courts as well as the IRS may attempt to limit the decision. Nevertheless, it seems clear, given Judge Tannenwald's dissent in the Tax Court and the outcome in the Third Circuit, that the disputed liability doctrine has renewed vitality as an independent exception to the general rule that COD income is taxable.[8]

The cases cited by the majority in *Zarin* all involved debts that were voidable or void *ab initio.*[9] In *Hall* the gambling debts were unenforceable by statute; in *Sobel* the purchaser had a right of rescission under the securities laws. Yet the $10,000 Example in *Zarin* merely recited that the debtor had some good faith dispute concerning repayment. As discussed above, would any good faith counterclaim that the debtor had against the lender (*e.g.,* the common counterclaim of "lender liability" for the debtor's financial condition) suffice to avoid COD income under the disputed liability exception? A particular debt could have a wide variety of contractual or equitable offsets, especially in seller-financed transactions. Such offsets include (1) violation of a covenant not to compete, (2) breach of warranty, and (3) agreement to share rehabilitation expenditures for properties with significant deferred maintenance. An extension of the disputed liability doctrine to all cases involving a potential counterclaim to the enforceability of debt would, of course, permit substantial gamesmanship in debt workouts. IRS and the courts also would have to devote significant attention to the meaning of "good faith."

Origin of the liability. Taxpayers might have a greater likelihood of success in asserting the disputed liability doctrine if the dispute arose—

[8] No cases have yet followed Zarin. Recently, in Schlifke, TCM 1991-19, the Tax Court acknowledged the disputed liability doctrine but did not need to analyze it. In Schlifke, the taxpayers rescinded a second mortgage loan three years after receiving the proceeds, because the lender had not given them the proper Truth-in-Lending disclosure statement. In the rescission accounting, the taxpayers were given full credit against the outstanding principal for all interest and finance charges paid and deducted by them over the three years. Judge Tannenwald—who dissented in Zarin—avoided the contested liability doctrine in Schlifke by upholding the IRS under the tax benefit rule. Zarin's usefulness also may be limited where the taxpayer has benefited from inclusion of the disputed liability in depreciable basis.

[9] Judge Tannenwald's dissent in the Tax Court, which was based on the application of the disputed liability doctrine, apparently was limited to such cases.

[10] S. Rep't No. 96-1035, 96th Cong., 2d Sess. 16 (1980).

[11] See Kalteyer, "Real Estate Workouts—Original Issue Discount Implications of Troubled Debt Restructurings," 43 Tax Lawyer 579 (1990).

[12] See generally Bramson, "Tax Consequences of Cancellation of Nonrecourse Debt Remain Unsettled," 73 JTAX 86 (August 1990).

[13] The Service has repeatedly challenged Fulton Gold Corp., 31 BTA 519 (1934), where the value of the collateral exceeds the mortgage. See Rev. Rul. 82-202, 1982-2 CB 36. The Service has announced that it will address Fulton Gold in another Ruling that, presumably, will expand the disagreement to situations where the mortgage exceeds the value of the collateral. See BNA *Daily Tax Report,* 5/15/90, at page G-7. See also the decision in Sutphin, Cls. Ct., 4/6/88.

[14] Even without further action by the Service, there are doubts as to the continued viability of Fulton Gold. In Gershkowitz, 88 TC 894 (1987), and Estate of Newman, TCM 1990-230 (both of which arose out of the same fact pattern), the court held that partners in a computer software venture that settled a $250,000 nonrecourse loan for $40,000 had COD income to the extent of their pro rata shares of the cancelled debt.

whether or not known to the parties at the time—when the debtor entered into the transaction that created the liability. There appears to be no reason why the doctrine would apply only to gambling debts or rescindable transactions. For example, a taxpayer who acquired property with a substantial environmental defect, such as the presence of asbestos, that was neither disclosed nor discovered at the time of the property's acquisition might have such a good faith dispute. The presence of the environmental defect might not necessarily make the contract rescindable, but would reduce the value of the property subject to purchase-money debt. Under the environmental liability statutes, both the subsequent purchaser and seller-lender could be potentially responsible parties. Therefore, an adjustment of the debt to the value of the property with the newly discovered defect ought to trigger application of the doctrine. Each party mistakenly believed at the time of the transaction giving rise to the debt that the value of the property was a particular amount. When the hidden defect reduces the value below that amount, where the lender bears some risk of the loss, then there is a good faith dispute as to at least part of the debt.

Preemption by Section 108(e)(5). One argument that taxpayers undoubtedly will face again is that Section 108(e)(5) is the sole means to avoid income arising from a reduction of debt that is purchase money or quasi-purchase money. The issue of the exclusivity of Section 108(e)(5) was apparently answered in the negative in *Sutphin*, Cls. Ct. 4/6/88, wherein the Service alleged that a taxpayer who paid off his mortgage at less than face recognized COD income. Section 108(e)(5) clearly did not apply because the debt was not purchase-money debt.

In *Sutphin,* the court held for the Service, but assumed that in proper circumstances COD income could be avoided where a debt incurred to acquire property is reduced in a fact situation outside Section 108(e)(5). In support of this assumption *Sutphin* cited *Hirsch*, 115 F.2d 656 (CA-7, 1940), in which the taxpayer avoided COD income on the reduction of a mortgage assumption. The Claims court distinguished *Hirsch* because there the value of the property did not exceed the debt after the reduction, while in *Sutphin* there was no allegation that the value of the taxpayer's residence was below the unpaid mortgage balance.

A careful reading of Section 108(e)(5) and the legislative history supports the argument that it is not preemptive. Section 108(e)(5) on its face applies "if" the statutory requirements are met. By comparison, Section 108(e)(1) specifically provides that Section 108 is the exclusive insolvency exception. Congress obviously could have but did not use such preemptive language in Section 108(e)(5).

A finding that property was received subject to a debt is not significant in applying the disputed liability doctrine.

The Tax Court in *Zarin* apparently cited the legislative history of Section 108(e)(5) for the proposition that it is exclusive. The Senate Report stated that "[t]his provision is intended to eliminate disagreements between the Internal Revenue Service and the debtor as to whether, in a particular case to which the provision applies, the debt reductions should be treated as discharge income or a true price adjustment."[10] Obviously, this statement can be read to support the view that Section 108(e)(5) is a nonexclusive safe harbor just as easily as claiming it is the exclusive means to adjust a debt incurred to acquire property or services. The legislative history, however, does not say it is intended to eliminate all disagreements, but only those "in a particular case to which the provision applies."

Section 108(e)(5) treats the debt reduction as a price adjustment and not debt cancellation. The disputed liability doctrine, whatever its breadth, is obviously broader than Section 108(e)(5), and may comfort debtors who do not fit within the section's narrow and mechanical limits. Section 108(e)(5) does not apply to partnerships or corporations that receive contributions of the property subject to the purchase-money debt, or where the creditor is a transferee or distributee (such as a shareholder receiving the installment obligation in a corporate liquidation) of the original seller.[11]

Nonrecourse debts. The proper breadth of the contested liability doctrine can be better judged when compared with the "nonrecourse exception" to COD income.[12]

In *Kirby Lumber,* as previously discussed, the Supreme Court held that a debtor has income from discharge of indebtedness because of the economic gain realized from the freeing of its assets from the debt. *Fulton Gold Corp.,* 31 BTA 519 (1934), effectively limited *Kirby Lumber* to situations involving recourse liabilities.[13] *Fulton Gold* involved a taxpayer who purchased property subject to a nonrecourse mortgage. The taxpayer later persuaded the holder of the mortgage to accept a cash settlement at less than the face amount. Several years later, the taxpayer sold the property and included the full original mortgage in basis. At issue was the correct basis of the property at the time it was sold. The board held that the reduction of the nonrecourse mortgage did not trigger COD income because there had been no release of assets previously offset by the mortgage. Thus, *Fulton Gold* suggests that perhaps the contested liability doctrine, which in *Zarin* involved an arguably nonrecourse debt, may be an extension or corollary of the nonrecourse exception.

As with the purchase-money debt reduction exception, however, there are limitations and conditions on the nonrecourse exception that apparently do not apply to the disputed liability doctrine. The most obvious difference is that the contested liability doctrine is not limited to situations where the debtor is expressly protected against personal liability in the event of a deficiency on foreclosure and repossession. In *Sobel,* the debt was fully recourse against the taxpayer subscribing for the

stock. Under the disputed liability doctrine, there is no apparent reason to distinguish between debts that are nominally recourse or nonrecourse. Either type could give rise to a good faith dispute to which the doctrine might be applied. This doctrine also is apparently on sounder legal footing than the nonrecourse exception.[14]

Conclusion

The Third Circuit's decision in *Zarin,* while not particularly helpful in explaining the limits of the disputed liability doctrine, nonetheless expands its potential application and is a welcome reversal of a troubling decision of the Tax Court. While the reversal might have been made more narrowly on alternate grounds, the court's use of the disputed liability doctrine illustrates the continued vitality of a potentially important concept in some loan workouts.

The doctrine may apply whenever a loan reduction relates to a good faith dispute that can be traced to circumstances in existence at the time of the debt's creation. The statements of the parties at such time and the recitation of the documents of the transaction that on their face create an enforceable debt are not necessarily determinative for tax purposes where the transaction is voidable or otherwise unenforceable.

It is unclear how broad the disputed liability exception is. If the Third Circuit decision stands, it may create an important new tool for taxpayers and practitioners to use in addressing COD in the ever-spiraling number of loan workouts. As long as the dispute is in good faith, the doctrine should not be abusive. As *Zarin, Hall,* and *Sobel* demonstrate, one cannot be relieved of a debt one does not owe. □