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NOTES

Discharge of Corporate Indebtedness at Less than Face Value under the Internal Revenue Code

*by Harvey Mahlig**

PRIOR TO 1939 whenever a corporation paid less than the face amount of an obligation in full satisfaction thereof, taxable income was realized to the extent of the difference.[1] There were three exceptions to the rule:[2] if the debtor were insolvent both before and after the transaction;[3] if the cancellation of indebtedness were a contribution to capital;[4] or if the cancellation amounted to a gift by the creditor.[5] These exceptions were applicable and allowable only to a limited extent and are not pertinent to the usual problem of the average corporation.

Where a corporation could discharge all or a portion of its indebtedness at less than face value the advantage of such action had to be weighed with the disadvantage arising from the inclusion of the savings in taxable income.[6] The fact that indebtedness could be purchased or retired at less than face amount is an indication that the corporation may not have too good a financial

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[1] United States v. Kirby Lumber Co., 284 U. S. 1 (1931).

[2] For a general discussion of the exceptions see Dunham, *"How to Eliminate the Tax on Debt Cancellation,"* 29 TAXES 127 (Feb. 1951).

[3] U. S. Treas. Reg. 86, 94, 101 Art. 22 (a)-14; U. S. Treas. Reg. 103, Sec. 19.22 (a)-14; U. S. Treas. Reg. 111, Sec. 29.22 (a)-14.

[4] U. S. Treas. Reg. 111, Sec. 29.22 (a)-14. Such section provides in part: "In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the original debt."

[5] Helvering v. American Dental Company, 318 U. S. 322 (1943); *but see* Commissioner v. Jacobson, 336 U. S. 28 (1949), which casts serious doubt on the validity of the *American Dental Company* case.

[6] Whether real income is earned by such a transaction may be subject to some debate, but nevertheless taxable income is realized under the general definition of taxable gross income. See Int. Rev. Code § 22 (a); *United States v. Kirby Lumber Co., supra,* note 1.

position. If, in addition to the amount required to acquire the indebtedness, the corporation had to secure the cash to pay the tax arising therefrom, the total cash requirement might very well be more than could be conveniently acquired or made available. In such case the opportunity to retire indebtedness at a discount would have to be foregone. Many such opportunities were available to corporations in the thirties, but because of the tax consequences the opportunities were not grasped.

Congress was urged to consider this problem and, as a result, in 1939 paragraph (9) was added to Section 22 (b) of the Internal Revenue Code.[7] Therein it was provided that there should not be included in the taxable income of a corporation the amount of income attributable to the discharge of any indebtedness as evidenced by a security, provided at the time of such discharge the corporation was in an unsound financial condition. In order to obtain the relief[8] provided, the corporation had to consent to a reduction in the basis of its assets.[9]

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[7] Revenue Bill of 1939 § 215 (a).

"(9) INCOME FROM DISCHARGE OF INDEBTEDNESS.—In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security (as hereinafter in this paragraph defined) if—

(A) it is established to the satisfaction of the Commissioner, or

(B) it is certified to the Commissioner by any Federal agency authorized to make loans on behalf of the United States to such corporation or by any Federal agency authorized to exercise regulatory power over such corporation,

that at the time of such discharge the taxpayer was in an unsound financial condition, and if the taxpayer makes and files at the time of filing the return, in such manner as the Commissioner, with the approval of the Secretary, by regulations prescribes, its consent to the regulations prescribed under section 113 (b) (3) then in effect. In such case the amount of any income of the taxpayer attributable to any unamortized premiums (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. As used in this paragraph the term "security" means any bond, debenture, note, or certificate, or other evidence of indebtedness, issued by any corporation, in existence on June 1, 1939. This paragraph shall not apply to any discharge occurring before the date of the enactment of the Revenue Act of 1939, or in a taxable year beginning after December 31, 1942."

[8] Primarily the relief consists of a deferment rather than reduction of tax, although in certain cases the tax can be deferred indefinitely.

[9] The basis is to be reduced under regulations prescribed by the Commissioner of Internal Revenue. A reduction in basis results either in reduced depreciation allowances or in increased gain or reduced loss on sale of the assets. U. S. Treas. Reg. 103, Sec. 19.113 (b) (3) promulgated by the Commissioner provide the method and the manner by which the basis of the assets is to be reduced.

The requirement that the corporation be in an unsound financial condition in order to benefit from this provision was objectionable. Normally a corporation in an unsound financial condition would have more pressing and immediate use for its cash than to use it to retire indebtedness. Only in an unusual situation would it appear that indebtedness could be retired under the conditions of the new paragraph. Consequently, in 1942, Congress eliminated the proviso relating to unsound financial condition and made the section applicable regardless of the corporation's financial condition.[10] The revision in 1942 also eliminated the requirement that the indebtedness be in existence on June 1, 1939.[11] Subsequent to 1942 the relief provided by Section 22 (b) (9) was available to all corporations and was applicable to all indebtedness evidenced by a security.[12]

The advantages of this relief provision were described in the 1939 Act to be available:

> "If the taxpayer makes and files at the time of filing the return, in such manner as the Commissioner, with the approval of the Secretary, by regulations prescribes, its consent to the regulations prescribed under Section 113 (b) (3) then in effect." [13]

At first blush it would appear to be a simple matter to arrive at a decision to make or not to make the election. The mechanics are simple enough. The corporation merely has to consent to the application of the regulations relating to basis reduction at the time of filing its return for the year in which the indebtedness was discharged. But there are many problems to be considered before an election can be made. A corporation operating at a profit would have to consider the effect of the basis reduction on the tax liability of future years, whether tax rates were likely to rise or fall and if the basis reduction could be applied to non-depreciable property.[14] Generally these problems

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[10] Rev. Act of 1942, § 114 (a).

[11] *Ibid.*

[12] Note that "Security" was defined to be "any bond, debenture, note or certificate, or other evidence of indebtedness." *Supra,* note 7.

[13] Int. Rev. Code § 22 (b) (9).

[14] Prior to the Revenue Act of 1951, the reduction in basis could be applied to non-depreciable property in certain instances; thus the tax incidence of the transaction could be almost indefinitely postponed. However, in the Report of the Senate Finance Committee with respect to the Revenue Act of 1951, the Committee stated that it understood the Commissioner would revise the Regulations changing the order in which the reduction is to be applied to depreciable and non-depreciable property so that "a reduction in

can be answered with a minimum of effort and a decision can be easily reached. A profitable corporation can estimate the tax consequences without too much difficulty.

As to a corporation operating at a loss, however, it might *appear* that no tax benefit can be obtained from the exclusion of the gain from the discharge of indebtedness for there would be no tax liability in the first place. The exclusion would merely increase the loss. Further, even though the corporation derived no tax benefit, the basis of property still would have to be reduced, having the effect of increasing income in future years. But such is not the case. Even though operating at a loss the benefits of Section 22 (b) (9) can be obtained by virtue of the loss carryover provisions of the Internal Revenue Code.[15] The additional loss created by excluding the gain from the discharge of indebtedness at less than face value could be used to offset income in some subsequent year, if there be income in a subsequent year. If the corporation continues to operate at a loss, the election under the section would not seem to be beneficial. Rather, it would seem that the election would be detrimental because the basis reduction would result in a reduced loss or an increased gain on the sale thereof.

Thus a dilemma is created. If a corporation, having a loss in the year in which the discharge took place, elects to exclude the gain, it may never obtain the tax benefits. If no election is made the chance to obtain this relief is lost. Of course, if the corporation can make a reasonable estimate of its future operations there may be no problem. But how many corporations operating at a loss can estimate future earnings or losses with any reasonable degree of certainty? In any event, it does not seem reasonable to condition relief on guesswork.

In *Denman Tire and Rubber Co. v. Comm.*[16] the petitioner purchased some of its own bonds at 50% of face value in 1941. Inasmuch as 1941 was a loss year, the required consent was not filed with its return for that year. In 1943 Denman realized a profit and in filing its return for that year, reduced this profit by the amount of the 1941 loss. If the consent required by Section

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the basis of non-depreciable property will be made only after the exhaustion of depreciable property or property subject to cost depletion." See note 18, *infra*.

[15] Int. Rev. Code § 122. At present losses of one year are first carried back to the preceding year and the balance of the loss, if any, is carried over to five subsequent years.

[16] 14 TC 706 (1950); aff'd. 192 Fed. 2d. 261 (6th Cir. 1951).

22 (b) (9) had been filed with its 1941 return, the loss available for carryover to 1943 would have been larger. In order to gain this benefit, an amended return for 1941 was filed excluding the gain arising from the discharged debt, thus increasing the 1943 loss. A consent to basis reduction was filed with the amended 1941 return. Because the consent was not filed with the original return, the Commissioner of Internal Revenue denied relief to the petitioner. Both the Tax Court and the Sixth Circuit Court of Appeals agreed with the Commissioner.

The decision against the taxpayer corporation is in harmony with the holding of the Supreme Court that an election exercisable in a first return cannot be made in an amended return.[17] Further, the Internal Revenue Code permits the exclusion from income only "if the taxpayer makes and files at the time of filing the return * * * its consent" [18] to a reduction of basis. In addition, the report of the Committee on Ways and Means of the House of Representatives states, "It is a condition upon the taxpayer's receiving the privilege of excluding the amount of income attributable to the discharge of indebtedness from gross income that *when filing its return* it consents to the regulations, which are in effect relating to adjustment of basis." [19]

Thus the relief afforded by Congress to corporations in financial difficulties turns out to be a gamble. If a corporation operates at a profit in a year in which a debt is discharged at less than face value, Section 22 (b) (9) will provide relief. But if, as is more likely, the corporation has a loss, it is forced to speculate on whether future years will be profitable.

Apparently realizing the inequities in this situation, Congress, in 1951, eliminated the words "if the taxpayer makes and files at the time of filing the return, in such manner as the Commissioner, with the approval of the Secretary, by regulations, prescribes, its consent" and inserted in lieu thereof, "if the taxpayer, at such time and in such manner as the Secretary by regulations prescribes, makes and files its consent." [20]

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[17] J. E. Riley Investment Co., 311 U. S. 55 (1940). The Court held that an amended return filed after the expiration of the statutory period for filing the original return was not a first return for the purpose of the election with respect to percentage depletion.

[18] Int. Rev. Code § 22 (b) (9).

[19] H. R. Rep. No. 855, 76 Cong. 1st Sess., 1939-2 CB 504. (Emphasis supplied.)

[20] Rev. Act of 1951, § 304 (a).

The report of the Senate Committee on Finance explains the change: [21]

> "Section 304 of your Committee's bill makes a technical amendment to Section 22 (b) (9) to allow for greater flexibility as to the time for filing the required consent to a reduction of basis. Under the present law, the taxpayer must file its consent with its return for the taxable year. The bill amends the Section to provide that the consent shall be filed at such time as the Secretary of the Treasury may prescribe. Under this amendment, the Department could continue to require that the consent be filed with the return in the ordinary case, but might make provision for filing of the consent at a later date in *appropriate hardship cases.*" (Emphasis supplied.)

As of the time of this writing, the Secretary of the Treasury has not issued proposed regulations concerning the filing of the consent under the changes made by the Revenue Act of 1951. It will be interesting to see what the definition of "appropriate hardship cases" will be. In view of the general principle that relief provisions are to be liberally construed,[22] a taxpayer should not be required to file the consent until such time as he can determine whether it would be advantageous to file. In view of the loss carryover provisions of the Internal Revenue Code it is possible that a taxpayer might not be able to determine the tax effect of such a consent for as many as five years.

Whether a five year delay in the filing of the consent will be allowed remains to be seen. A consent filed after such a delay would require changes in the net loss of each prior year due to the change in the basis in the year the debt was discharged.[23] Possibly the Secretary may determine that administrative difficulties would be out of proportion to the benefits if a five year delay were to be allowed. On the other hand it would seem that a corporation which suffered losses for five consecutive years would be more of a "hardship case" than a corporation which suffered losses in but one or two years.

While income tax laws need not be fair, equitable or reasonable[24] it would seem that where Congress provides relief for a taxpayer, that taxpayer should be able to obtain such relief with-

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[21] Sen. Fin. Com. Rep. No. 781, 82 Cong. 1st Sess., IRB 1951-24-13712.

[22] Mertens "Law of Federal Income Taxation," § 309, Note 2.

[23] See Note 15, *supra.*

[24] What justification, for example, existed for taxing gain (prior to 1952) on the sale of a personal residence where the vendor immediately purchased a new residence with the proceeds of the old?

out becoming involved in a guessing contest concerning profits of future years. It is hoped that the Secretary will be sympathetic and not require that consents be filed until such time as the tax effects of the discharge of indebtedness at less than face value can be determined.