RECENT CASES

INCOME TAX CONSEQUENCES OF CANCELLATION OF INDEBTEDNESS

The problem of the income tax consequences of the cancellation or reduction of indebtedness has recently been given another partial answer in the Supreme Court's decision in *Com'r v. Jacobson.*[1] There the taxpayer, who was solvent though in financial difficulties, purchased his own bonds at a discount from his creditors.[2] The Court held that there was a taxable gain to the extent of the difference between the face value of the bonds and the amount for which the taxpayer purchased them.

In the *Jacobson* case, as in all the cancellation of indebtedness cases, the initial question is whether the cancellation results in income to the debtor. Assuming an affirmative answer, the question shifts to whether that income may be excluded from the debtor's taxable gross income. The Internal Revenue Code does not offer an explicit answer to either question. Section 22(a)[3] defines gross income in extremely general terms. The exclusions from gross income authorized by Section 22(b),[4] with one rather narrow exception,[5] are not expressly applicable to gains of this type.

As a result of this lack of specific coverage by the Code, the courts have been left to determine in what situations the gain arising from a cancellation of indebtedness constitutes taxable income. The basic doctrine was established in *U.S. v. Kirby Lumber Co.*[6] where the Supreme Court held that a solvent corporate taxpayer realized taxable income by the open-market purchase at a discount of its own bonds originally issued at par.[7] The rationale of the case was,

[1] 69 S. Ct. 358 (1949).

[2] Some of the bonds were purchased by the taxpayer himself, some by his agents, and some through a bondholders' committee. The Court found that in effect all the bonds had been purchased in direct dealings between the taxpayer and the bondholders, all of whom knew that the bonds were being purchased for the taxpayer.

[3] 53 Stat. 9 (1939), 26 U.S.C.A. § 22(a) (1948); cf. Reg. 111, § 29.22(a)–13 (1943).

[4] 53 Stat. 10 (1939), 26 U.S.C.A. § 22(b) (1948).

[5] See 53 Stat. 875 (1939), 26 U.S.C.A. §§ 22(b)(9), 113(b)(3) (1948).

[6] 284 U.S. 1 (1931); cf. Old Colony Trust Co. v. Com'r, 279 U.S. 716 (1929); U.S. v. Boston & Maine R. Co., 279 U.S. 732 (1929).

[7] A similar decision was reached in Helvering v. American Chicle Co., 291 U.S. 426 (1934), in which the taxpayer, having assumed the bonded indebtedness of a company it purchased, bought the bonds at a discount. However, "the obligation to be retired must be one which unconditionally subjects the obligor's assets to liability for the payment of a fixed amount." Corp. De Ventas, etc. v. Com'r, 130 F. 2d 141, 143 (C.C.A. 2d, 1942). Where nothing of value was ever received in return for the obligations, the bonds having been issued as a divi-

"As a result of its dealings it [the debtor] made available . . . assets previously offset by the obligation of bonds now extinct."[8]

The imposition of a tax on the basis of the *Kirby* doctrine may be rather harsh in some circumstances. In all of the reduction or cancellation[9] of indebtedness cases the debtor's gain is a decrease of liabilities rather than an increase in assets. Cancellation is likely to occur either when interest rates have increased and the debtor is able to purchase his own obligations at a discount, or when a debtor, because of his straitened financial circumstances, is hard put to meet his obligations as they fall due and is able to make some arrangement with his creditors. Cases along the lines of the *Kirby* situation are frequently representative of the former type of cancellation. The courts began to develop two satellite concepts which seemed to mitigate the harshness of the *Kirby* doctrine in the latter type of cancellation, where its application likely would be especially burdensome to the debtor. These two satellites were the reduction-in-purchase-price and insolvency rules.

The reduction-in-purchase-price concept was applied where the debt was originally incurred in conjunction with the purchase of property which, at the time of the cancellation, had declined in value to an amount less than the face amount of the purchase obligation.[10] Under these circumstances, the debtor was not viewed as having received income.[11] The fact that the value of the property

dend to stockholders, no income arises from the purchase of the bonds at a discount. Com'r v. Rail Joint Co., 61 F. 2d 751 (C.C.A. 2d, 1932). It has been held that the cancellation by stockholders of debts owed them by the corporation did not result in taxable income, but were contributions to capital. Carroll-McCreary Co. v. Com'r, 124 F. 2d 303 (C.C.A. 2d, 1941). A discussion of the circumstances under which the debtor's purchase of its obligations results in a cancellation and receipt of income may be found in Com'r v. Pittsburg &. W.V. Ry. Co., 172 F. 2d 1010 (C.C.A. 3d, 1949).

[8] U.S. v. Kirby Lumber Co., 284 U.S. 1, 3 (1931); cf. Reg. 111, § 29.22(a)-17-1(c) (1943).

[9] Throughout this note, the term "cancellation" refers to both cancellation and reduction of indebtedness.

[10] In Hirsch v. Com'r, 115 F. 2d 656 (C.C.A. 7th, 1940), the petitioner had purchased real estate for $29,000 in 1928, paying $10,000 in cash and assuming mortgage indebtedness of $19,000. In 1936 the balance due was $15,000. At that time the property had declined in value to $8,000, and the mortgagee accepted that amount in full settlement of the mortgage debt. Compare Ralph W. Gwinn, T. C. Memo., Doc. No. 108144, 3 T. C. M. 548 (1944); Mark W. Allen & Co., T. C. Memo., Doc. No. 111343, 1 T. C. M. 887 (1943); Tarleau, Federal Income Tax Considerations Applicable to Cancellation of Indebtedness, 5th Annual N.Y.U. Inst. on Fed. Taxation 664, 668 (1947). See cases decided before the early reduction-in-purchase-price cases cited in note 11 infra: Com'r v. Coastwise Transportation Corp., 71 F. 2d 104 (C.C.A. 1st, 1934), cert. den. 293 U.S. 595 (1934); L. D. Coddon & Bros., Inc., 37 B. T. A. 393, 396 (1938). But see Des Moines Improvement Co., 7 B. T. A. 279 (1927). In Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926), the amount of money lost was greater than the difference between the amount of money borrowed and the amount paid in settlement of the debt.

[11] Helvering v. A. L. Killian Co., 128 F. 2d 433 (C.C.A. 8th, 1942); Hirsch v. Com'r, 115 F. 2d 656 (C.C.A. 7th, 1940); Hextell v. Huston, 28 F. Supp. 521 (Iowa, 1939). There is a tendency to restrict the application of the reduction-in-purchase-price doctrine to cases in which the cancellation transaction actually directly relates to the original purchase price and

had so declined was some indication that the debtor might be in difficult financial circumstances. Moreover, the courts imposed the additional requirement that the cancellation be brought about in direct dealings with the creditor. This also tended to associate the reduction-in-purchase-price doctrine with situations in which the debtor was in weak financial condition rather than with those situations where there had been a decline in the market value of securities for other reasons. The application of the *Kirby* doctrine in the former situation would operate to deprive the debtor of some of the advantage gained by the cancellation and to that extent to restore him to a precarious financial position.

The reduction-in-purchase-price doctrine met with criticism on the ground that it is, in effect, a means of taking an unrealized capital loss on the property into consideration in determining whether there is taxable income when indebtedness is cancelled.[12] It was observed that the decline in value requirement allowed the gain arising from the application of the *Kirby* rule to be offset by unrealized losses on property if those losses were greater than the gain.[13] This authorization is an unusual, indirect exception to the general doctrine that

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the debt cancelled is a purchase money obligation. See Fifth Ave.-Fourteenth St. Corp. v. Com'r, 147 F. 2d 453 (C.C.A. 2d, 1945); 54 Harv. L. Rev. 1071 (1941), noting Hirsch v. Com'r, supra. But see Des Moines Improvement Co., 7 B. T. A. 279 (1927) (decided before the Kirby case).

[12] See Surrey, The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness, 49 Yale L.J. 1153 (1940); Darrell, Discharge of Indebtedness and the Federal Income Tax, 53 Harv. L. Rev. 977 (1940). But see 2 Mertens, Law of Federal Income Taxation § 11.20 (1942).

[13] The reduction-in-purchase-price doctrine seems to be based on Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926). There money had been borrowed in Germany, repayable in marks, by the taxpayer for its wholly owned subsidiary which lost the money in the performance of construction contracts. The obligation was later satisfied by payment of an amount substantially smaller than that borrowed, the value of the mark having fallen. The Court held that the taxpayer thereby did not realize taxable income, calling the transaction in which the obligation was satisfied a mere diminution of loss. Until the Kirby case, the Kerbaugh-Empire decision was thought to stand for the proposition that the satisfaction of a debt by payment of less than its face amount did not result in taxable gain. See Indianapolis St. Ry. Co., 7 B. T. A. 397, 399 (1927). Because of its highly questionable identification of two analytically separate transactions—the loss of the money borrowed by the subsidiary, a separate tax entity, and the subsequent satisfaction of the debt—and because of the case's conflict with the doctrine of the periodic nature of the tax, the Kerbaugh-Empire case was heavily criticized and is of doubtful validity as a precedent. However, it has never been overruled, the Kirby case merely distinguishing it on the ground that it was shown that the taxpayer there had suffered a loss while in the Kirby case the final nature of the dealings had not been revealed. Compare Helvering v. American Chicle Co., 291 U.S. 426 (1934). In any event, the idea of "looking at the transaction as a whole" to determine gain or loss, upon which is based the reduction-in-purchase-price doctrine, stems from the Kerbaugh-Empire case. For discussion of that case and the entire field of debt cancellation see the material cited in note 12 supra, and Tarleau, Federal Income Tax Considerations Applicable to Cancellation of Indebtedness, 5th Annual N.Y.U. Inst. on Fed. Taxation 664 (1947); Lynch, Some Tax Effects of Cancellation of Indebtedness, 13 Fordham L. Rev. 145 (1944); Warren and Sugarman, Cancellation of Indebtedness and Its Tax Consequences, 40 Col. L. Rev. 1326 (1940).

neither loss nor gain is recognized except in the year in which it is actually realized; generally, loss is not realized until final disposition.

If the reduction-in-purchase-price doctrine is to be used as a method of taking unrealized loss on property into consideration, it could logically be applied to all cancellation of indebtedness cases in which the value of the property has declined, even where it is worth more than the face amount of the obligation. Thus the tax would be levied on the difference between the amount of freed assets (the amount of freed assets is the difference between the face amount of the obligation and the amount paid in its satisfaction) and the amount of the decline in the value of the property.

Although it may be difficult to defend the indirect recognition of an unrealized loss in circumstances in which the property has declined in value, there is some reason for continuing to restrict the application of the reduction-in-purchase-price doctrine to cases in which the property at the time of the cancellation is worth less than the face amount of the obligation. It is only in that situation that the term "reduction in purchase price" is at all realistically descriptive of the transaction. The creditor most likely would not be able to collect the full amount of the debt by foreclosing on the property, and by asserting his claim for the balance of the obligation he might force the debtor into insolvency proceedings. In that situation it is probable that the creditor would agree to a readjustment of the contract price. The restriction of the application of the reduction-in-purchase-price doctrine to these situations may be an indication that the courts were largely concerned with aiding debtors in extreme financial straits rather than all debtors who have had a cancellation of indebtedness and whose property had declined in value. Once the property value had been determined, this restriction provided a simple, objective standard for ascertaining those cases in which the *Kirby* rule would work the greatest hardship.

A full understanding of the reduction-in-purchase-price doctrine as a limitation on the *Kirby* rule cannot be achieved without consideration of the tax benefit rule. The application of that rule to some cancellation of indebtedness cases has resulted in the imposition of a tax where the reduction-in-purchase-price doctrine would otherwise seem applicable. This rule, which is now in part embodied in the Code,[14] was developed by the courts in situations exemplified by a case in which the taxpayer receives payment of a debt that has previously been deducted from income as worthless.[15] The amount so received is charged to income in the year of receipt, not because gain is received in this taxable year but because a deduction in a previous year has proved to have been too large. The

[14] 56 Stat. 812 (1942), 26 U.S.C.A. § 22(b)(12) (1948), provides that the recovery during the taxable year of bad debts, etc., may be excluded from gross income of that year only to the extent to which the bad debt did not result in a reduction of tax in the year in which it was accrued.

[15] See Com'r v. Liberty Bank & Trust Co., 59 F. 2d 320 (C.C.A. 6th, 1932) (amounts received by taxpayer in payment of debts previously deducted from income as worthless are chargeable to income for the years in which received).

tax benefit rule is applied to cancellation of indebtedness cases where the original cost of the good or service received in exchange for the obligation has been taken as a deduction from income in the year of purchase. The taxpayer received a tax benefit by virtue of the deduction of the full purchase price. When the cancellation occurs it appears that this benefit was excessive; the amount deducted from income was larger than the amount ultimately paid. The tax benefit rule, as applied here by the courts,[16] adjusts for this by requiring that the difference between the face amount of the debt and the amount paid in its satisfaction be treated as if it were income in the year of cancellation.[17] The Code itself does not make the rule applicable to the cancellation of indebtedness cases.

Because it operates only to correct what has turned out to be an error in a previous year, the tax benefit rule has been subjected to the criticism that it is contrary to the doctrine that the tax is assessed "on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period. . . ."[18] In those cancellation of indebtedness cases in which the cancellation occurs as a result of negotiations concerning only the indebtedness, there is an identification of transactions which occur over a series of years. The identification of the transaction in which the debt was originally incurred and the transaction in which it is cancelled is unusual under the income tax which ordinarily considers the transactions of a single year.

An alternative explanation of the result that follows from the traditional application of the tax benefit rule to the cancellation of indebtedness cases, and that is not subject to the same criticism, suggests itself. It was noted that the reduction-in-purchase-price doctrine requires that the purchased property must have declined in value. Because there has been a tax benefit through the deduction from income of the original purchase price, decline in value cannot be recognized and the reduction-in-purchase-price doctrine is not applied.[19] If that doctrine is inapplicable, the rule of the *Kirby* case compels the conclusion that income is actually received in the year of the cancellation because of the "free-

[16] In Helvering v. American Dental Co., 318 U.S. 322 (1943), the Court partially relied on the reduction-in-purchase-price analogy although the cancelled debt was for back rent and accrued interest, both of which had been taken as deductions in the years in which they accrued. The reliance on that doctrine there seems unjustifiable. The Court was able to find other grounds for its decision that the cancellation of those obligations did not result in taxable income.

[17] B. F. Avery & Sons, Inc., 26 B. T. A. 1393, 1400 (1932); Helvering v. Jane Holding Corp., 109 F. 2d 933, 939 (C.C.A. 8th, 1940). On this basis the tax benefit rule would seem applicable whenever the reduction-in-purchase-price doctrine is applied to cases involving depreciable property. In those cases the taxpayer gets an excessive tax benefit from depreciation deductions based on the original purchase price. See 54 Harv. L. Rev. 1071 (1941), noting Hirsch v. Com'r, 115 F. 2d 656 (C.C.A. 7th, 1940). Consistency requires that income should be recognized to the extent of the excessive depreciation deductions. This logical result has not been attained.

[18] Burnet v. Sanford & Brooks Co., 282 U.S. 359, 363 (1931).

[19] A narrower variation of the tax benefit rule operates here to prevent the recognition of a decline in the value of the property.

ing" of the debtor's assets that results. This explanation has not been articulated in the opinions.[20]

In the *Jacobson* case the Court found that the gain was income within Section 22(a), applying the freeing of assets doctrine of the *Kirby* case.[21] The reduction-in-purchase-price concept was not applied, since the transactions did not involve purchase money obligations and because it was not shown that the debt had been incurred in the purchase of property or that the property purchased with the borrowed money had declined in value.

The second set of satellite rules which mitigates the harshness of the *Kirby* rule comes into play if the debtor was insolvent at the time of the cancellation. Under these rules the purchase and retirement of outstanding obligations for less than face value will not result in income to the debtor if he is insolvent even after the cancellation.[22] Although assets may be freed from one liability, they continue to be unavailable to the debtor, since they are offset by other obligations. The tax benefit rule does not prevent the application of the insolvency rule as it does the reduction-in-purchase-price rule.[23] Where the debtor is insolvent before the cancellation and solvent immediately after, the *Kirby* and insolvency rules meet. The two have been reconciled by a compromise which results in the holding that income is received to the extent that assets are freed from the claims of creditors.[24] Since the debtor in the *Jacobson* case was solvent, these rules were not applicable there.

[20] "The controlling decisions establish that when such items of income are so entered as accrued debt by a solvent taxpayer returning on the accrual basis, the items are deemed in law to be restored to income if and when the debt is subsequently forgiven." B. F. Avery & Sons, Inc., 26 B. T. A. 1393, 1400 (1932); cf. Helvering v. Jane Holding Corp., 109 F. 2d 933, 939 (C.C.A. 8th, 1940).

[21] In demonstrating that the gain constituted income, the Court used an argument based on a 1939 amendment to Section 22(b). This amendment, 53 Stat. 875 (1939), 26 U.S.C.A. § 22(b)(9) (1948), excludes from the gross income of corporations the amount of any income attributable to the discharge of any indebtedness of the taxpayer evidenced by a security if the appropriate regulations are complied with. See Reg. 111, § 29.22(b)(9)-1,-2; § 29.113 (b)(3)-1,-2 (1943). The amount so excluded must be applied in the reduction of the basis of any of the taxpayer's property in accordance with the provisions of an amendment to 53 Stat. 875 (1939), 26 U.S.C.A. § 113(b)(3) (1948). The Court reasoned that unless the gains derived by debtor corporations were income before the adoption of the amendments, there was no need for their passage. And since Section 22(a) does not distinguish between natural persons and corporations, gains accruing to the former must have remained taxable after the passage of the amendments. Com'r v. Jacobson, 69 S. Ct. 358, 366 (1949). Justice Frankfurter, dissenting in Helvering v. American Dental Co., 318 U.S. 322, 331 (1943), made a similar point.

[22] Main Properties, Inc., 4 T. C. 364 (1944); Kramon Development Co., 3 T. C. 342 (1944); What Constitutes Income and Loss, 47 Harv. L. Rev. 1258, 1259 (1934).

[23] See Haden Co. v. Com'r, 118 F. 2d 285 (C.C.A. 5th, 1941), cert. den. 314 U.S. 622 (1941). In Fifth Ave.-Fourteenth St. Corp. v. Com'r, 147 F. 2d 453, 457 (C.C.A. 2d, 1945) the court of appeals said: "If the insolvent taxpayer 'buys in' its debts, or any of them, for an amount equal to or greater than the amount which would have been paid to creditors upon the taxpayer's liquidation, then there is no realized taxable gain; where, however, the taxpayer 'buys in' its debts for less than such an amount, then, to that extent there is realized taxable gain." The other cases cited do not support this view.

[24] Lakeland Grocery Co., 36 B. T. A. 289 (1937); cf. the earlier decisions in Dallas Transfer & Terminal Warehouse Co. v. Com'r, 70 F. 2d 95 (C.C.A. 5th, 1934); E. B. Higley & Co.,

Once it is determined that the gain arising from the cancellation of indebtedness is income, the question arises whether that income falls within any of the exclusions from gross income in Section 22(b) of the Code. In *Helvering v. American Dental Co.*[25] the Supreme Court decided that such income might be classed as a gift within the meaning of Section 22(b)(3).[26] In that case the solvent taxpayer owed one creditor back rent and several past due bills for merchandise, the latter represented by interest-bearing notes. Both rent and interest had been deducted as expenses in the taxpayer's returns for the years in which they had accrued. In face to face dealings with the creditor, in conjunction with negotiations for a new lease, both items of indebtedness were cancelled upon payment of less than the face amounts.

The Court reasoned that the cancellation of indebtedness in a face to face transaction with the creditor was "the receipt of financial advantages gratuitously"[27] and hence a gift. The fact that the reasons or motives for the cancellation by the creditor might have been selfish was thought to be immaterial. Apparently, however, the Court thought that there was an "intent" to make a gift, and that "intent" was manifested by showing that the creditor cancelled a portion of the debt without receiving any valuable consideration.[28]

Later cases indicated that if there was consideration for the cancellation there could be no gift, and taxable income was received. It is not clear whether more than simple contract consideration was required or whether the consideration must have moved from the debtor.[29] And because of the necessity for a donative "intent," the *American Dental* rule was thought by some to be inapplicable

25 B. T. A. 127 (1932). See Reg. 111, § 29.22(a)–13(b) (1943). For criticism of the insolvency rules see the articles cited in notes 12 and 13 supra. For discussion of the effect of the National Bankruptcy Act, see Claridge Apartments Co. v. Com'r, 323 U.S. 141, 146 (1944); Lynch, Some Tax Effects of Cancellation of Indebtedness, 13 Fordham L. Rev. 145 (1944); Surrey, The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness, 49 Yale L. J. 1153, 1184 (1940).

[25] 318 U.S. 322 (1943).

[26] 53 Stat. 10 (1939), 26 U.S.C.A. § 22(b)(3) (1948). Reg. 77, Art. 64, Rev. Act. of 1932, provided, "If . . . a creditor merely desires to benefit a debtor and without any consideration therefore cancels the debt, the amount of the debt is a gift from the creditor to the debtor. . . ." This provision was omitted in Reg. 86, Art. 22(a)–14, Rev. Act. of 1934, and it does not appear in the present Regulations.

[27] Helvering v. American Dental Co., 318 U.S. 322, 330 (1943).

[28] The taxpayer in the Jacobson case attempted to draw a distinction between the terms "donative intent" and "donative motive," claiming, "Petitioner is confusing the terms 'intent' and 'motive,' and is really saying that if the motive for the cancellation is a business one, the cancellation cannot be gratuitous. As this Court held in the American Dental Co. case, the motives are not controlling. The common, accepted definition of the term 'gift' shows that the motives of the donor have no bearing on whether a particular transaction is a gift. The significant fact is that in the present case the creditors intended to cancel a portion of their debt without receiving any valuable consideration. What their motives were is of no importance." Respondent's Brief in the Supreme Court, at p. 11.

[29] Compare Shellabarger Grain Products Co. v. Com'r, 146 F. 2d 177 (C.C.A. 7th, 1944); Reliable Incubator & Brooder Co., 6 T. C. 919 (1946); Liberty Mirror Works, 3 T. C. 1018 (1944).

where the cancellation was brought about by arm's-length, open-market transactions.[30]

In the *American Dental* case the Court recognized that where a debtor dealt directly with his creditor, cancellation would have been unlikely if the debtor had been well able to pay the full amount of the obligation. In keeping with the tendency of the courts to circumvent the *Kirby* rule in situations where the debtor was in difficult financial circumstances, the gift concept was developed. The use of the gift category made it unnecessary to go into the difficult fact questions of property valuation and insolvency that were involved in the two satellites of the *Kirby* rule.

Perhaps because it was simple to apply and did not aggravate the difficult financial circumstances of debtors, the lower courts began to apply the gift concept in a wide variety of cases. In some, the finding that there was a gift was far from realistic.[31] In others it was clear that the financial condition of the debtor had little or nothing to do with the cancellation.[32] More recently the Tax Court seems to have recognized these excesses and has attempted to develop some limitations upon the *American Dental* doctrine. Thus the doctrine was not applied where an open market existed for the cancelled obligations, regardless of whether they were purchased in that open market.[33] In another case it was held that there was income to the debtor from the purchase of its obligations at a discount where the debtor had not had close personal or business relations with the creditor.[34] And in the *Jacobson* case the Tax Court refused to apply the *American Dental* rule to bonds purchased for the taxpayer by his agents or by a bondholders' committee and found that only where the taxpayer personally made the purchase was there a gift.[35]

It was in this context that the Supreme Court, in the *Jacobson* case, after finding that taxable income had been realized by virtue of the cancellation, held that the income was not a gift and therefore taxable.

Section 22(b)(9) of the Code,[36] which provides for the exclusion from gross income of the gains arising from a corporation's purchase at a discount and can-

[30] Compare Fifth Ave.-Fourteenth St. Corp. v. Com'r, 147 F. 2d 453 (C.C.A. 2d, 1945).

[31] Manhattan Soap Co., T. C. Memo., Doc. Nos. 182, 112632, 112633, 3 T. C. M. 257 (1944), holding that a compromise settlement of a federal tax liability resulted in a gift to the taxpayer. Compare cases collected in Dunham, Cancellation or Adjustment of Indebtedness, 7th Annual N.Y.U. Inst. on Fed. Taxation 1346 (1949).

[32] McConway & Torley Corp., 2 T. C. 593 (1943), finding a gift where the debt of a wholly owned subsidiary corporation to its parent was cancelled at the instance of a creditor of the parent so that the subsidiary could declare a dividend which the parent could use to reduce its debt to its creditor.

[33] Warner Co., 11 T. C. No. 53 (1948).

[34] Edmont Hotel Co., 10 T. C. 260 (1948).

[35] Jacobson v. Com'r, 6 T. C. 1048 (1946). See note 2 supra. The court of appeals applied the American Dental doctrine to all of the purchases. 164 F. 2d 594 (C.C.A. 7th, 1947).

[36] 53 Stat. 875 (1939), 26 U.S.C.A. § 22(b)(9) (1948).

cellation of its own securities, served as the basis for one argument. The Court said that the Section described gains similar to those in the *Jacobson* case, and if that type gain when received by corporations was considered a gift within Section 22(b)(3), there was no need for Congress to provide a special exclusion in 22(b)(9).[37] A weakness of this argument lies in the identification of the gains in the *Jacobson* case with those covered by Section 22(b)(9). Corporations are more likely than individuals to acquire their own obligations in the open market. However, the gift concept is applicable to face to face transactions, not open-market transactions. Congress, in passing Section 22(b)(9), may have intended to extend some of the benefits of exclusion from gross income to cases in which 22(b)(3) was inapplicable. Furthermore, the tax consequences of 22(b)(3) and 22(b)(9) are different. The former results in a complete exclusion. On the other hand, 22(b)(9), coupled with Section 113(b)(3),[38] which requires that the basis of the corporation's property be reduced by an amount equal to the benefit arising from the cancellation,[39] results merely in a temporary exclusion. The gain is spread out over the life of the property by decreased future deductions for depreciation unless the taxpayer sells the capital asset. In that event the provisions covering adjustment of basis in 113(b)(3) assure the full realization of the gain, but the full gain will not be taken into account under the provisions of Section 117.[40]

The Court in the *Jacobson* case held that the facts did not present a proper situation in which to apply the *American Dental* doctrine. Although the debtor was in straitened financial circumstances, the property securing the bonds exceeded the amount of the indebtedness; that property produced some income; and the debtor was solvent at the time of the cancellation. Perhaps in the hope that future cases might develop a workable limitation on the *American Dental* rule, the Court did not overrule that case. Instead, it attempted to distinguish it, saying that the release of an open account for rent or for interest was more likely to be a gift transaction than the sale of outstanding securities. That each bondholder in the *Jacobson* case was acting from selfish motives was emphasized. Each was selling his bonds for the best price obtainable in the belief that by so doing he would secure the greatest possible advantage under his own particular circumstances.

The same may, however, be said of all such transactions arising in commercial contexts, including that in the *American Dental* case. In the business world, if the law is to be at all realistic, the concept of the "economic man" should not be by-passed. Until benevolent or personal motives appear—until the transaction becomes noncommercial—the creditor will only cancel indebtedness when he feels that he will minimize his probable losses or maximize his probable

[37] Com'r v. Jacobson, 69 S. Ct. 358, 366 (1949).

[38] 53 Stat. 875 (1939), 26 U.S.C.A. § 113(b)(3) (1948).

[39] See note 20 supra.

[40] 53 Stat. 50 (1941), 26 U.S.C.A. § 117 (1945), which provides for capital gain and loss.

gains.[41] He will make this decision either where he feels that the full amount of the debt will not be collectible when it falls due, where he wants the benefit of some money before the obligation matures, or because he feels that by not forcing payment in full he will be able to continue a profitable business relationship with the debtor.

It appears that the unrealistic concept of a "gift in the commercial world" has been abandoned, although it is true that the *Jacobson* decision did not expressly overrule the *American Dental* case.[42] If some satisfactory limitation of the gift concept is devised, it may be applicable to some cases. However, it is not likely that such a limitation will be formulated. If so, the answer to the question of when the cancellation of indebtedness results in taxable income is again to be found in the principle of the *Kirby* case and the two satellite concepts, constructed about reduction in purchase price and insolvency, that were developed around that principle prior to the *American Dental* decision.

RIGHTS OF BENEFICIARIES UNDER FACILITY OF PAYMENT CLAUSES

The plaintiff was the named beneficiary of four small industrial insurance policies which contained facility of payment clauses. The clauses provided that "[i]f the Beneficiary does not surrender this policy with due proof of death within 30 days after death of the insured, . . . the death benefit will, upon surrender of this Policy with due proof of death, be paid to the executor or administrator of the Insured, but . . . the Company may . . . pay the benefit to any relative by blood or connection by marriage . . . or to any person appearing to the Company to be equitably entitled . . . because of having incurred expense for . . . medical attention or burial of the Insured." The plaintiff, not possessing the policies, was unable to present them for payment within the 30-day period; she ultimately brought suit against the insurer and the person retaining the policies —the insured's widow. The company interpleaded the plaintiff, the widow, and the administrator, and paid the proceeds of the policies into court. It was held that upon the expiration of the initial 30-day period the beneficiary assumed a status under the facility of payment clause similar to that of any other person to whom the insurer might have elected to pay the benefits. The plaintiff accordingly had no right to compel payment, and since the insurer had failed to elect a recipient of the proceeds, only the administrator had a right to receive payment. *Matejicska v. Metropolitan Life Ins. Co.*[1]

Industrial insurance policies pay benefits averaging about $250; premiums

[41] Compare Haden Co. v. Com'r, 118 F. 2d 285 (C.C.A. 5th, 1941), cert. den. 314 U.S. 622 (1941) (decided before the American Dental case and holding that because the cancellation of indebtedness benefited the creditor, the cancellation did not constitute a gift).

[42] Justice Rutledge, concurring with the majority, was of the opinion that the two cases were inconsistent. Com'r v. Jacobson, 69 S. Ct. 358, 370 (1949).

[1] 335 Ill. App. 81, 80 N.E. 2d 278 (1948).