Zarin v. Commissioner Revisited and Some Methodologies for Determining COD Income

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ZARIN V. COMMISSIONER REVISITED
AND SOME METHODOLOGIES FOR
DETERMINING COD INCOME

PHILIP G. COHEN

ABSTRACT

The focus of this Article is a revisit of a very well-known and much written about Third Circuit Court of Appeals decision, Zarin v. Commissioner, concerning whether the taxpayer had COD income. Zarin dealt with whether a compulsive and unlucky gambler could avoid COD income when he settled with the casino for substantially less than what he owed. Along with a plethora of diverse third-party assessments of the case, the judges who heard the case and its appeal were also divided. The Tax Court opinion was decided by an eleven to eight vote for the Internal Revenue Service (IRS), with three separate dissenting opinions, and was followed by a Third Circuit reversal, with a two to one split of the judges. In a much-criticized decision, the divided Third Circuit Court of Appeals reversed a split Tax Court and held that the hapless gambler did not have discharge of indebtedness income. While many esteemed scholars have made plausible arguments to the contrary, this Article concludes that Zarin should have been determined to have COD income from his settlement with the casino. Zarin was not subject to tax when he received the gambling chips because both parties had an understanding it would be repaid. This tax benefit he received at the time of the loan resulted in COD income upon the indebtedness’ settlement for less than what was owed, unless an exception applied, and none should have in this case.

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This Article will also examine some of the theories for determining if a taxpayer has COD income and how they relate to Zarin. The loan proceeds methodology, or a variation thereof, is the proper means of establishing whether a taxpayer has COD income, prior to considering whether any of the exceptions apply. The freeing of assets and the Kerbaugh-Empire form of the whole transaction approaches should no longer be followed by the courts.
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INTRODUCTION

Among the litany of items specifically listed as included in gross income in section 61 is “[i]ncome from the discharge of indebtedness.”1 This is commonly referred to by the acronym COD, short for cancellation of debt income. Section 1082 further addresses income from the discharge of indebtedness, including providing for several exclusions.3 Most of the exclusions require, as a quid pro quo, a reduction of favorable tax attributes.4 Thus, often when section 108 applies, the taxpayer achieves a deferral rather than a permanent tax benefit.5 As observed by one scholar, “[t]he determination of whether a taxpayer must include a discharge of indebtedness in gross income requires ... a two-part analysis. It must first be determined whether gross income conceptually exists pursuant to an analysis under section 61.”6 Assuming that this “results in a determination that gross income does in fact exist, it must then be determined whether any portion of such amount may be excluded from gross income under section 108 ... [or a non-statutory exclusion].”7 The focus of this Article is a revisit of a very well-known and much written about Third Circuit Court of Appeals decision,8 Zarin v. Commissioner,9 concerning whether the taxpayer had COD income.

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1 I.R.C. § 61(a)(12).
4 McMahon & Simmons, supra note 3, at 449.
5 Id.
7 Id. at 609.
8 Professor Lawrence Zelenak observed that “[n]o non–Supreme Court federal income tax case in recent decades has generated more commentary from tax academics and practitioners than Zarin.” Lawrence Zelenak, Cancellation-of-Indebtedness Income and Transactional Accounting, 29 VA. TAX REV. 277, 321 (2009).
The Article will also examine some of the theories for determining if a taxpayer has COD income and how they relate to Zarin. One commentator described Zarin as "a perplexing and difficult case, both theoretically and under existing tax law." Another scholar referred to it as "a wonderfully wacky case." Zarin dealt with whether a compulsive and unlucky gambler could avoid COD income when he settled with the casino for substantially less than what he owed. Along with a plethora of diverse third-party assessments of the case, the judges who heard the case and its appeal were also divided. The Tax Court opinion was decided by an eleven to eight vote for the IRS, with three separate dissenting opinions, and was followed by a Third Circuit reversal, with a two to one split of the judges. This writer has the fortunate vantage point of thirty plus years of hindsight.

In a much-criticized decision, the divided Third Circuit Court of Appeals reversed a split Tax Court and held that the hapless gambler, who in the year in question was in the seventy percent tax bracket, did not have a discharge of indebtedness income. There are some credible arguments made by very esteemed scholars that the holding, but generally not the reasoning, of the Third Circuit, that Zarin should not have had taxable income, was proper. While admittedly not entirely free from doubt, these

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10 See infra Part I.
11 Daniel Shaviro, The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption, 45 TAX L. REV. 215, 221 (1990). He may have been referring to the Tax Court decision since that was the focus of most of the article; although, he added an addendum to address the Third Circuit decision, which was released shortly before the article went to press. See id. at 252–58.
13 Zarin, 92 T.C. at 1084; Zarin, 916 F.2d at 111–12.
14 Zarin, 92 T.C. at 1084–116; Zarin, 916 F.2d at 110–18.
16 Zarin, 916 F.2d at 110–18.
17 Id. at 112.
18 Id. at 110.
writers conclude that the right position is that he should have been taxed.20

Before David Zarin sustained gambling losses at the Resorts International Hotel in Atlantic City, New Jersey, and even prior to the codification of the treatment of income from the discharge of indebtedness, the Supreme Court in United States v. Kirby Lumber Co. determined that a debtor had taxable income upon the reduction of a debt for an amount less than what it owed.21 An understanding of why the Third Circuit’s decision in Zarin was amiss requires some background into the conceptual frameworks for the determination of COD income. This begins with Kirby Lumber.

I. BACKGROUND—CONCEPTUAL FRAMEWORKS FOR THE DETERMINATION OF COD INCOME AND THE LEGACY OF KIRBY LUMBER

In a two-paragraph opinion,22 the Supreme Court held that where the taxpayer, “the Kirby Lumber Company, issued its own bonds for $12,126,80023 for which it received their par value24 ... [and] later in the same year it purchased in the open market some of the same bonds at less than par, the difference” was taxable income.25 The Court, focusing on the taxpayer’s increase in net worth, reasoned that “there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct.”26 As to why Kirby Lumber was able to buy its bonds back at a reduced price, Professors Marvin

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20 Dodge, supra note 19, at 683 n.33; Johnson, supra note 19, at 697–99; Shaviro, supra note 11, at 258.
21 284 U.S. 1, 1 (1931).
22 Professor Deborah H. Schenk characterized the decision as “one of the shortest Supreme Court opinions ever to pack such a wallop.” Schenk, supra note 12, at 137.
23 While not mentioned in the opinion, Professor Schenk indicated that Kirby Lumber did not in fact receive cash for the bonds, but instead, “they were issued for preferred stock and accrued dividend arrearages.” Id. at 138.
24 $1,078,300.
26 Id. at 3.
A. Chirelstein and Lawrence Zelenak noted that while “the facts in Kirby are not fully developed, it seems reasonable to assume that
the company was able to repurchase its bonds at a discount because of a general rise in the market rate of interest.”  

While there is a wide consensus that the Court’s decision in Kirby Lumber was correct, the perceived rationale “that addi
tional assets ... became ‘available’ to the taxpayer” has been subject to much criticism. Professors Boris Bittker and Lawrence Lokken opined in their seminal treatise, Federal Taxation of Income, Estates and Gifts, that the Kirby Lumber “result is entirely justifiable, but the opinion’s cryptic explanation set afloat several erroneous ideas leading to a confusing patchwork of rules and exceptions that dominates the area to this day.” They added that the Kirby Lumber reference to “no shrinkage of assets” has created “[a] particularly troublesome legacy,” which is the “tendency of some courts to read Kirby Lumber as holding that taxable gain resulted from the freeing of assets on the cancellation of indebtedness, rather than the cancellation itself.” They indicated that “[i]n actuality, income results from the discharge of indebtedness because the taxpayer received more than is paid back, not because assets are freed of offsetting liabilities on the balance sheet.” In a similar vein, Professors Chirelstein and Zelenak asked “[c]ould the taxpayer have avoided inclusion by showing that its net worth had been reduced by losses or by a decline in the value of other property?” The answer should be no.

While there is little doubt that “for a discharge of indebtedness to generate gross income, the discharge must result in an accession to wealth for the taxpayer,” there is some disagreement

28 Id.
30 Kirby Lumber Co., 284 U.S. at 3.
31 See Bittker & Lokken, supra note 29, ¶ 7.1.
32 Id.
33 Id.
34 Chirelstein & Zelenak, supra note 27, at 59.
by the courts and scholars as to the proper conceptual framework for making this determination.\textsuperscript{36} Professor James L. Musselman commented that “cases dealing with the issue of income from discharge of indebtedness have resulted in a variety of theories and results, none of which have been uniformly accepted by courts or commentators.”\textsuperscript{37} He faults “improper analysis”\textsuperscript{38} by the Supreme Court in \textit{Kirby Lumber} and \textit{Bowers v. Kerbaugh-Empire Co.},\textsuperscript{39} discussed \textit{infra}, and the fact that “courts subsequently dealing with the issue of income from discharge of indebtedness in different factual settings have had to give deference to those precedents in trying to reach a rational decision.”\textsuperscript{40} In trying to reach an “equitable result,”\textsuperscript{41} relating to COD income, Professor Musselman asserted that the “courts seized upon any precedent or idea they could find to rationalize their equitable result. Understandably, this has resulted in the confusing patchwork of theories and rationales for [many] decisions ....”\textsuperscript{42}

Before discussing methodologies for determining COD income that are arguably explicitly derived from the language in \textit{Kirby Lumber}, it should be noted that the loan replacement approach is a much more conceptually sound theory even though its connection to \textit{Kirby Lumber} may be less clear. A conceptual framework that originated from the words used in \textit{Kirby Lumber}, the freeing of assets theory (also known as net worth or balance sheet theories)\textsuperscript{43} has been utilized by “[n]umerous courts”\textsuperscript{44} but also has been the subject of “withering criticism.”\textsuperscript{45} The methodology was articulated by Professor Deborah H. Schenk as follows:

\begin{quote}
[A] debtor recognizes income when a debt is discharged because the discharge decreases the debtor's liabilities but does not decrease the debtor's assets. The income arises from the increase in
\end{quote}

\textsuperscript{36} See Musselman, supra note 6, at 610–30.
\textsuperscript{37} Id. at 631.
\textsuperscript{38} Id.
\textsuperscript{39} 271 U.S. 170, 170–75 (1926).
\textsuperscript{40} Musselman, supra note 6, at 631–32.
\textsuperscript{41} Id. at 632.
\textsuperscript{42} Id.
\textsuperscript{43} See, e.g., CHIRELSTEIN & ZELENAK, supra note 27, at 60–61.
\textsuperscript{44} Schenk, supra note 12, at 144.
\textsuperscript{45} Id.
A determination of whether the taxpayer has income requires an examination of the taxpayer’s balance sheet at the time the debt is discharged.\footnote{\textit{Id.}}

Professor Lawrence Zelenak commented that

\begin{quote}
[un]der [this] approach, the manner in which the debt was incurred in the prior year, and in particular the consideration (if any) that the taxpayer received in exchange for incurring the debt, is irrelevant to the determination of the tax consequences of the cancellation of the debt in the current year.\footnote{Zelenak, \textit{supra} note 8, at 281.}
\end{quote}

He explained that “[t]his analysis looks only to the events of the year of the cancellation of the debt; the manner in which the debt was created in some earlier year does not matter.”\footnote{\textit{Id.}}

In their breakthrough article on COD income, Professors Boris I. Bittker and Barton H. Thompson described both the origin of and the error in the use of the freeing of assets theory:

\begin{quote}
A second source of confusion in \textit{Kirby Lumber} was the Court’s assertion that the transaction “made available $137,521.30 assets previously offset by the [obligation to repay].” ... A particularly troublesome legacy of the above passage has been the tendency of some courts to read \textit{Kirby Lumber} as holding that it is \textit{the freeing of assets} on the cancellation of indebtedness, rather than the cancellation itself, that creates a taxable gain. Such reasoning misses the point. Income results from the discharge of indebtedness because the taxpayer received (and excluded from income) funds that he is no longer required to pay back, not because assets are freed of offsetting liabilities on the balance sheet. Debtors who ultimately pay back less than they received enjoy a financial benefit whether the funds are invested successfully, lost in a business venture, spent for food and clothing, or given to a charity.\footnote{Boris I. Bittker \& Barton H. Thompson, Jr., \textit{Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.}, 66 CALIF. L. REV. 1159, 1165 (1978) (footnotes omitted) (quoting United States v. Kirby Lumber, 284 U.S. 1, 3 (1931)). Professor Thompson became a professor after the article was published. \textit{Biography: Barton H. “Buzz” Thompson, Jr.}, STAN. L. SCH., https://law.stanford.edu/directory/barton-thompson/ [https://perma.cc/A84X-PJN5].}
\end{quote}
Professor Schenk pointed out that “if Kirby Lumber was able to repurchase its bonds at a discount, they were not worth face value immediately before the repurchase.”\textsuperscript{50} Professors Bittker and Lokken added that “[i]f the company’s assets and liabilities to creditors had been valued at their fair market values, the company’s net worth would have been the same before and after the repurchase.”\textsuperscript{51} Professor Schenk criticized this methodology, by observing that

the solvency or net worth of a taxpayer is not a determinant of the taxability of amounts received in other situations. For example, it is clear that the receipt of salary by an insolvent taxpayer is clearly taxable income even though the debtor remains insolvent after using the cash to reduce the debt.\textsuperscript{52}

A Supreme Court case decided a few years prior to Kirby Lumber, Bowers v. Kerbaugh-Empire Co.,\textsuperscript{53} had its own troubling legacy which included its brief examination by the Court in Kirby Lumber.\textsuperscript{54} In Kerbaugh-Empire, the taxpayer owned stock in a company engaged in the construction business that had borrowed money pre–World War I, from the Deutsche Bank of Germany.\textsuperscript{55} The loans were payable in German marks or their equivalent in U.S. gold coin.\textsuperscript{56} The funds were utilized in the unsuccessful construction business and repaid to the Alien Property Custodian in substantially devalued marks after the war.\textsuperscript{57} The “difference between the value of the marks borrowed at the time the loans were made and the amount paid to the Custodian was $684,456.18.”\textsuperscript{58} The Commissioner argued this was taxable income, but the taxpayer prevailed on the theory that “the loss was less than it would have been if [the] marks had not declined in value; but the mere diminution of loss is not gain, profit or income.”\textsuperscript{59} Professor Schenk commented that “there

\begin{thebibliography}{99}
\footnotesize
\bibitem{50} Schenk, supra note 12, at 144.
\bibitem{51} BITTKER & LOKKEN, supra note 29, ¶ 7.1.
\bibitem{52} Schenk, supra note 12, at 145.
\bibitem{54} Kirby Lumber Co., 284 U.S. at 1–2.
\bibitem{55} Kerbaugh-Empire Co., 271 U.S. at 171–72.
\bibitem{56} Id. at 172.
\bibitem{57} Id. at 172–73.
\bibitem{58} Id. at 173.
\bibitem{59} Id. at 175.
\end{thebibliography}
was an increase in net worth in Kerbaugh-Empire,” as there was in Kirby Lumber.\textsuperscript{60} She reasoned that

\begin{quote}
[s]uppose a taxpayer has $100 of liabilities and $40 of assets. A creditor discharges a $20 loan. ... Only someone who has no understanding of negative numbers could fail to see that T's net worth has increased, or to put it another way, that there has been a decrease in T's negative net worth.\textsuperscript{61}
\end{quote}

Professor Schenk expressed a persuasive and widely shared disagreement with the distinction the Court made in Kirby Lumber from Kerbaugh-Empire\textsuperscript{62} in that, in the latter case, “the transaction as a whole was a loss ....”\textsuperscript{63} This distinction spawned another approach by some courts and scholars for determining whether a transaction gave rise to COD income. This methodology is referred to as the “the whole transaction theory”\textsuperscript{64} (also known as “the transaction as a whole”).\textsuperscript{65} Professor Schenk found this theory, at least as it has been historically utilized, as “not only theoretically wrong, [but] completely impractical.”\textsuperscript{66} One example she gave of why the historic whole transaction approach should be a non-starter was a scenario wherein a “taxpayer borrows $20,000, invests it in his business, and loses the entire amount. Most likely, the loss would be deductible, and if he also were permitted to exclude the

\begin{quote}
\textsuperscript{60} Schenk, \textit{supra} note 12, at 145.
\textsuperscript{61} \textit{Id.} But see Zelenak, \textit{supra} note 8, at 287 (freeing of assets methodology could be viewed as having some merit if the “focus[ is] on an increase in the taxpayer's net worth, or an improvement in the taxpayer's balance sheet [irrespective of whether or not there is positive net worth]”). He wrote that the freeing-of-assets was always an unfortunate way of expressing the idea that COD income is based on an increase in the taxpayer's net worth .... If the rationale for taxation of COD income is that it increases the taxpayer's net worth or improves the taxpayer's balance sheet, nothing in that rationale requires or even suggests that there should be no COD income simply because the taxpayer does not have a positive net worth after the debt cancellation. In short, the insolvency exception [to COD income] was based on an imperfect understanding of the net worth (NW) theory ....
\textit{Id.}
\textsuperscript{62} See Schenk, \textit{supra} note 12, at 145–47.
\textsuperscript{63} United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931).
\textsuperscript{64} See, \textit{e.g.}, Schenk, \textit{supra} note 12, at 145.
\textsuperscript{65} Bittker & Thompson, \textit{supra} note 49, at 1162.
\textsuperscript{66} Schenk, \textit{supra} note 12, at 146.
$20,000 when the lender discharges the debt, he effectively would have a double deduction.” 67 This method is also unworkable. 68 Professor Schenk wrote that “[i]n order to apply it, one has to know the use to which the borrowed funds were put. This is a completely implausible approach due to the fungibility of money.” 69

Professors Bittker and Thompson provided the following summary of the historic whole transaction theory’s source and why it is defective:

Kirby Lumber carried forward from Kerbaugh-Empire the theory that the taxability of a debt discharge depends on the profitability of “the transaction as a whole,” requiring consideration not merely of whether the taxpayer borrowed more than it repaid but also of whether the use of the borrowed funds was profitable. It is usually impossible to make this latter determination, however, since the borrowed funds are ordinarily absorbed into the business so completely that tracing the travels of interchangeable dollars lacks even the surface plausibility that it could claim in Kerbaugh-Empire. Even where funds can be traced to a particular project, the attribution is artificial since in most cases borrowing frees up funds that the debtor can then use to finance other projects. It is therefore misleading to limit an examination of “the transaction as a whole” to the fate of only those projects directly financed with the borrowed funds. Tying the tax treatment of debt discharge to the fate of the borrowed funds is also irrational for another reason. Since the amount borrowed will ultimately be capitalized, expensed, or nondeductible depending on how the borrowed funds are used, the fate of the funds will already be reflected in the debtor’s net income. If borrowed funds are invested and lost in an ill-fated business venture, the full amount borrowed will generally be deductible as a business loss. If the taxpayer later settles the debt for less than its issue price, an exclusion of the difference because the funds were lost would be tantamount to a double deduction for a single loss. 70

Professors Martin J. McMahon, Jr. and Daniel L. Simmons indicated that Kerbaugh-Empire “is now treated as an anomaly.” 71

67 Id.
68 Id.
69 Id.
70 See Bittker & Thompson, supra note 49, at 1162–63.
71 McMahon & Simmons, supra note 3, at 424. Professor Schenk, however, noted that Kerbaugh-Empire has never been overruled. See Schenk, supra note 12, at 148.
They pointed out that “the Service, the Tax Court, and the Court of Appeals for the Ninth Circuit have concluded that Kerbaugh-Empire Co. lacks precedential authority in light of subsequent Supreme Court decisions.”

In contrast, the loan proceeds theory is embraced by many courts and scholars. This approach is also known as “mistake-correction.” Credit is given by scholars to the article mentioned above by Professors Bittker and Thompson for influencing courts and fellow academics as to the merit of this approach.

Professors McMahon and Simmons succinctly explained the loan proceeds concept as,

if a debt is cancelled and the borrower is relieved of the duty to repay the loan, the cancellation of the debt has tax consequences because the benefit of receipt of cash at the time of the borrowing without realization of income is offset by elimination of repayment, producing an overall economic benefit to the borrower.

Professors Douglas A. Kahn and Jeffrey H. Kahn elaborated on this methodology as follows: “When someone borrows money, the borrower does not recognize income because it is assumed that the borrower will repay the loan. In effect, the debt prevents the borrower from recognizing income because of the assumption that the loan will be repaid.” Furthermore, “forgiveness of the debt removes the obstacle to tax the borrower on the amount of the loan that would have been income when

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72 McMahon & Simmons, supra note 3, at 424–25. The Ninth Circuit decision, Vukasovich, Inc. v. Commissioner, 790 F.2d 1409 (9th Cir. 1986) was cited and heavily relied upon by the Tax Court in Zarin in rejecting taxpayer’s contention that he had no COD income because “the settlement merely reduced the amount of his loss and did not result in income.” Zarin v. Comm’r, 92 T.C. 1084, 1092 (1989).

73 See, e.g., Schenk, supra note 12, at 147.


75 See generally Bittker & Thompson, supra note 49 and accompanying text.


77 See McMahon & Simmons, supra note 3, at 419–20.

78 See Kahn & Kahn, supra note 3, at 166.
borrowed if there had not then been an obligation to repay.” 79 In other words, the extinguishment of all part of the debt, results in the debtor “enjoy[ing] an accretion [or more commonly referred to as an “accession”] to wealth.” 80 Professors Kahn and Kahn observed that “[i]t is not the debtor’s increase in net worth that is taxable; rather, it is a tax on the amount that previously was thought to have been borrowed and turned out to have just been an enrichment of the ‘borrower.’” 81

While this latter notion of when COD income should arise is intellectually compelling, the Court has provided mixed signals that it has rejected the freeing of assets theory entirely for the loan proceeds approach. 82 Professor Schenk pointed to United States v. Centennial Savings Bank 83 as embracing both theories. 84 She quoted the following passage:

Borrowed funds are excluded from income in the first instance because the taxpayer’s obligation to repay the funds offsets any increase in the taxpayer’s assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates. 85

A few years earlier, however, in Commissioner v. Tufts, the Court seemed to shift away from the freeing of assets approach. 86

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79 Id.
80 See Schenk, supra note 12, at 148.
81 See Kahn & Kahn, supra note 3, at 166.
82 See Schenk, supra note 12, at 151 (noting that “[l]egislative history indicates that when Congress revamped the insolvency rules as part of the Bankruptcy Act of 1980, it abandoned the freeing-of-assets theory in favor of the loan proceeds approach”).
84 See Schenk, supra note 12, at 148.
85 Schenk, supra note 12, at 148 (citing Centennial Savings Bank, 499 U.S. 573). In Centennial Savings Bank, the Court held, in relevant part, that penalties collected by the taxpayer from depositors making early withdrawals was not “income by reason of the discharge ... of indebtedness,” and thus taxpayer was not entitled to exclude such amounts under an exception provided in section 108(a)(1). Centennial Savings Bank, 499 U.S. at 579–81.
86 Comm’r v. Tufts, 461 U.S. 300, 313 (1983). Gregory M. Giangiordano noted that “[i]n Tufts, the Supreme Court essentially changed the test for determining discharge of indebtedness income from the previous ‘freezing of assets’ approach ... to a consideration of the tax symmetry of the overall loan
The reference to both theories by the Court in *Centennial Savings* for finding COD income is not an aberration. For example, in *Commissioner v. Jacobson*, a solvent taxpayer, albeit one in “straitened financial circumstances,” was, because of his financial situation, able to buy back his own obligations at a discount. The Court noted that “[i]n each sale the bondholder sought to minimize his probable loss by getting as much as possible, directly or indirectly, from the maker of the bonds as the one available purchaser of them.” The Court found that this resulted in the taxpayer having “realized an immediate financial transaction.”

Gregory M. Giangiordano, *Discharge of Indebtedness Income—Zarin v. Commissioner*, 64 TEMP. L. REV. 1189, 1195 (1991) (citing *Tufts*, 461 U.S. at 313)). Another commentator, Chad J. Pomeroy, was in accord. He explained that:

> The Supreme Court, though, in *Commissioner v. Tufts*, seemed to move away from the freed assets justification. In *Tufts*, the taxpayer owned property that was subject to a nonrecourse mortgage (an obligation for which he was not personally liable). The taxpayer transferred the property to a buyer, and the buyer assumed the nonrecourse debt. The Court held that the taxpayer realized income equal to the amount of the discharged mortgage. The Court did not look at whether the discharge freed any of the taxpayer’s assets; instead, it focused on the *symmetry* of the loan transaction. The Court reasoned that the taxpayer did not have to pay taxes on the original loan because the government assumed that he would eventually repay the debt using after-tax dollars. The Court further reasoned that, if the government’s prediction proved incorrect (the taxpayer ended up not repaying the obligation), the taxpayer would have “effectively ... received untaxed income at the time the loan was extended” [citing *Tufts*, 461 U.S. at 310]. So, when it becomes clear that a taxpayer is not going to repay the debt (in other words, when it becomes clear that the taxpayer received untaxed income), the IRS is allowed to remedy this error by taxing the amount of unpaid debt as income. It does not matter whether the taxpayer discharged a recourse mortgage or a nonrecourse mortgage (an action that would not free up assets because the taxpayer was never personally liable for the debt); what matters is that the IRS’s treatment of the back end of the transaction should be consistent with its treatment of the front end of the transaction. *Tufts* changed the rationale for debt-discharge income. No longer is a debt discharge included in income only when it frees assets.

Pomeroy, *supra* note 74, at 1681–82 (citations omitted).


88. *Id.*
gain from his purchase of these bonds at a discount. By that acquisition he was enabled, at will, to cancel them and thus discharge himself from liability to pay them."

Signaling adherence to the freeing of assets concept, the Court indicated that this “improved his net worth by the difference between their face amount and the price he paid for them.”

Two sentences later, the Court used language more reminiscent of the loan proceeds methodology, when it stated “[i]n the first instance he had received the full face amount in cash for these bonds so that his repurchase of them for 50 percent, or less, of that amount reflected a substantial benefit ....”

It is worth noting that Congress at one point was sympathetic to taxpayers in situations like those in Jacobson and Kirby Lumber. While section 108(a)(1)(A) and (B) today provide an exception to COD income for those taxpayers in a formal bankruptcy proceeding or who are insolvent, prior to the Tax Reform Act of 1986, “relief under § 108 was made available not only to debtors in distress (like the taxpayer in Jacobson), but also to Kirby-type taxpayers who might be in perfectly healthy condition and simply benefitting from a general rise in market rates of interest.”

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89 Id. at 38.

90 Id.

91 See Jacobson, 336 U.S. at 38–39; see also McMahon & Simmons, supra note 3, at 420. While not germane to the issue of methodologies for the determination of COD income, it should be noted that in Jacobson, the Supreme Court also rejected taxpayer’s argument that the gain was an excludable gift and distinguished its earlier decision, Helvering v. American Dental Co., 318 U.S. 322 (1943). Jacobson, 336 U.S. at 28 (holding that a gift could arise in the context of a commercial settlement). Professor Schenk noted that in Commissioner v. Duberstein, 363 U.S. 278 (1960), “the Supreme Court [subsequently] crafted a definition of a gift for income tax purposes that in most cases would preclude a gift where debt is discharged in a commercial setting.” Schenk, supra note 12, at 153.

92 Chirelstein & Zeilenak, supra note 27, at 62.

93 Id. See generally I.R.C. § 108. Professor Schenk elaborated on the history of then section 61(a)(12) and section 108:

Congress codified the Kirby Lumber rule in § 61(a)(12) [currently § 61(a)(11)] when it adopted the Internal Revenue Code of 1954. Previously, the provision with respect to COD income was only in the regulations. The 1939 Code, however, added the predecessor of §§ 108 and 1017. The original version of § 108
While Professor Zelenak referred to the approach he advocated for determining COD income as “transactional accounting” or “whole-transaction analysis,” this methodology represents a clarification of the loan proceeds approach. He explicitly acknowledged that “[t]he [loan proceeds/mistake correction] LP/MC theory should be the only theory of debt cancellation income.” His amplification of the loan proceeds methodology centered on “the premise that a discharge of a no-benefit debt should be nontaxable under the [loan proceeds/mistake correction] LP/MC analysis ....” That is, the loan proceeds concept is based on the notion that when the taxpayer incurred the indebtedness initially, he was not taxed, i.e., the taxpayer received a tax benefit because of the understanding that the loan would be repaid and therefore, at that point, there was no accession to wealth. If there was no tax benefit, COD income should not arise upon the debt settlement. Professor Richard C. E. Beck, who was quoted by Professor Zelenak, explained that, “[t]o the extent the debtor did not originally receive cash or other loan proceeds in exchange for incurring the debt, its cancellation should not be taxable.” Professor Zelenak pointed out that Professor Beck had “an important caveat: ‘Even if the debtor does receive value [at the time the debt originated], no COD income should arise unless the value would have been taxable absent the debt.’”

permitted corporate taxpayers in ‘unsound financial condition’ to exclude the amount of any income attributable to discharge of indebtedness that was evidenced by a security. In 1942, Congress eliminated the requirement that the corporation be in unsound financial condition. In the 1954 Code, the rule was rewritten to include individuals as well as corporations. In 1986, this election was eliminated except for insolvent and bankrupt taxpayers. When Congress subsequently added two other exemptions, it extended § 108 to apply to them.

Schenk, supra note 12, at 149.

94 See Zelenak, supra note 8, at 280, 294.
95 Id. at 294.
96 Id. at 297.
97 See id.
98 See id.
100 Id.; see Zelenak, supra note 8, at 298 (quoting Beck, supra note 99, at 167).
“[i]f the debtor buys or borrows nothing in exchange, incurrence of a debt is a loss of net worth. Cancellation of such a debt does no more than restore former net worth and is not gain for precisely the same reason that a return of capital is not gain.”101

Professors Kahn and Kahn advocated what they refer to as a “transactional approach” but not the whole transaction methodology as it was applied in Kerbaugh-Empire, which they opine “had been wrongly decided”102 and resulted in the “transactional approach to COD issues [being] saddled with a bad reputation.”103 Their formulation of the transactional approach was as follows:

The gist of the transactional approach is to examine the entire transaction beginning with the creation of the debt and ending with the cancellation. If the debtor did not obtain a tax benefit because of the debt, the debtor should not have COD income. The tax benefit could be the receipt of cash or other property that would have been income to the debtor if the presence of the debt had not prevented the recognition of income. The tax benefit could be a deduction or the acquisition of basis that was made possible by the presence of the debt.104

Professor Zelenak acknowledged that a “problem [often] arises of how to identify a no-benefit debt. It is easy enough to provide a general verbal formulation of the test for a no-benefit debt but applying the test to particular fact patterns has produced considerable disagreement among commentators and the courts.”105

An example cited by Professor Zelenak of the difficulty courts have, at times, applying the no-benefit debt concept was Bradford v. Commissioner.106 In that case, the taxpayer’s husband owed a bank approximately $305,000.107 He was concerned that the debt might adversely affect his firm’s seat on the New York Stock Exchange.108 He convinced the bank to replace part of his debt with a $205,000 note by his wife “without receiving

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102 See Kahn & Kahn, supra note 3, at 164.
103 Id.
104 Id. at 200.
105 See Zelenak, supra note 8, at 297.
106 See generally Bradford v. Comm’r, 233 F.2d 935 (6th Cir. 1956).
107 Id. at 936.
108 Id.
any consideration.”

Her note was later replaced, at the bank’s request, with two notes, one for $105,000, to which she pledged collateral, and a note for $100,000, which was unsecured. Three years later, in 1946, after a bank examiner compelled $50,000 of the second note to be written off, the bank informed the taxpayer that it was agreeable to sell the $100,000 note for $50,000, and her brother-in-law purchased the note for $50,000. The Tax Court determined that she had an ordinary income of $50,000. The taxpayer appealed this decision on grounds that: 1) this was essentially a gift from the bank and 2) “that because she received nothing when the note was executed by her ..., she did not realize income in 1946 when the note was cancelled for less than its face amount, even if the cancellation was not a gift.”

The Sixth Circuit, citing Jacobson, among other authorities, indicated that “[w]e cannot say the Tax Court’s ultimate finding that there was no gift ... was clearly erroneous ....” As to whether the taxpayer had COD income in 1946, the Sixth Circuit reversed the Tax Court’s decision and held for the taxpayer. In its reasoning, the court first rejected the application of the freeing of assets approach. The court stated that “[a] mechanical application of these principles would of course support the Tax Court’s decision. Looking alone to the year 1946 ... it is obvious that when $100,000 of the petitioner’s indebtedness was discharged for $50,000 in that year, she realized a balance sheet improvement of $50,000 ....” The court then announced that “[w]e cannot agree with the Commissioner, however, that these principles are to be applied so mechanically.” The court, citing and discussing Kerbaugh-Empire, observed that it “has been called ‘a frequently criticized and not easily understood decision[ ]’ ... [but] has not been overruled.” The court then stated:

109 Id.
110 Id.
111 Id.
112 Id.
113 Id.
114 Id. at 937.
115 Id. at 939.
116 Id. at 938.
117 Id.
118 Id. at 938–39.
Whatever validity the Kerbaugh-Empire Co. decision may now have on its own facts, it remains an authority for the proposition that in deciding the income tax effect of cancellation of indebtedness for less than its face amount, a court need not in every case be oblivious to the net effect of the entire transaction.\textsuperscript{119}

The court, then however, pivoted, to a loan proceeds approach.\textsuperscript{120} Professor Zelenak stated that in Bradford, the Sixth Circuit “appl[ied] the LP/MC [loan proceeds/mistake correction] theory to the Tax Court’s no-benefit finding ... [and] concluded that ‘by any realistic standard the petitioner never realized any income at all from the transaction’ and ruled in Mrs. Bradford’s favor.”\textsuperscript{121} The court based this conclusion on the fact that “[t]he Tax Court unequivocally found as a fact that petitioner received no consideration when she executed this note ... [and t]his finding is not clearly erroneous ....”\textsuperscript{122} While the rejection of the utilization of a balance sheet/net worth test was correct, its application of loan proceeds with net benefit approach is questionable. Professor Zelenak noted that “[t]he majority view among commentators[, including himself,] is that Bradford was wrongly decided; the court should have rejected as clearly erroneous the Tax Court’s findings that Mrs. Bradford received nothing from the bank in exchange for the note.”\textsuperscript{123} He was of the opinion, with which this writer concurs, “that the [original] debtor substitution ... was the equivalent of Mrs. Bradford’s borrowing $205,000 cash from the bank and giving the cash to Mr. Bradford, followed by Mr. Bradford’s using the gifted cash to repay his debt to the bank.”\textsuperscript{124}

As to the focus of this Article, Zarin, Professor Zelenak opined “that it provides another illustration of how difficult it sometimes is to apply the LP/MC analysis of COD income, contrary to the expectation of Bittker and Thompson that COD income analysis would always be simple under the LP/MC framework.”\textsuperscript{125}

Professor Schenk observed that the various theories of when COD income should or should not occur “do not necessarily

\textsuperscript{119} Id. at 939.
\textsuperscript{120} Id.
\textsuperscript{121} Zelenak, supra note 8, at 304 (citing Bradford, 233 U.S. at 938).
\textsuperscript{122} Bradford, 233 U.S. at 936 n.1.
\textsuperscript{123} Zelenak, supra note 8, at 304.
\textsuperscript{124} Id.
\textsuperscript{125} Id. at 324–25 (referencing Bittker & Thompson, supra note 49, at 1165).
produce the same result.” She gave as an example, similar to one offered by other commentators, including Professor Zelenak, wherein “T promises to make a payment to X (in a situation that would not produce a deduction when the payment is made), and T is ultimately freed from that obligation.” She stated that “[u]nder the freeing-of-assets theory, T would have COD income because his balance sheet is no longer encumbered by the obligation. Under the loan proceeds theory, however, T would have no income because he had not received any income or property at the time he incurred the obligation.” She indicated that “[u]nder the whole transaction approach, it would be necessary to know what T did with the proceeds of the loan.”

In reaching the above conclusion, Professors Kahn and Kahn cited an example provided by the Second Circuit decision, Commissioner v. Rail Joint Co. The hypothetical offered by the Second Circuit was as follows:

Suppose that a taxpayer validly contracts in 1930 to give $1,000 to a charity in 1931, and in the latter year compromises the obligation by paying $500 in full settlement. If the taxpayer returns his income on a cash basis, this transaction cannot possibly increase his income. The giving of the obligation certainly added nothing to income in 1930, and the payment of it in 1931 will appear only as a deduction of the sum actually paid in that year to the use of a charitable corporation. If he were

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126 Schenk, supra note 12, at 149. Professors Chirelstein and Zelenak, referring to “freeing of assets” and “loan proceeds” methodologies, commented, however, that “[t]he choice between two rationales for the taxation of debt cancellation income usually makes no difference, because the same income inclusion would be required under either rationale.” See Chirelstein & Zelenak, supra note 27, at 61.

127 See Zelenak, supra note 8, at 294.

128 Schenk, supra note 12, at 149.

129 Id.

130 Id.

131 See Kahn & Kahn, supra note 3, at 165-66.

132 Id. at 165 n.20.

133 Comm’r v. Rail Joint Co., 61 F.2d 751, 752 (2d Cir. 1932).
to report on an accrual basis and were allowed to deduct from gross income for 1930 the $1,000 liability incurred in that year, then it might be said that the settlement of the liability in 1931 for a less sum had released the difference to general uses of the taxpayer and the sum so released should appear as income then received in order that the returns for both years might truly reflect the effect of the whole transaction upon the net income.\textsuperscript{134}

\textit{Rail Joint} concerned a corporation paying a dividend in the form of the corporation’s bond with a face value of $2 million.\textsuperscript{135} These bonds were later purchased at less than face value with the difference credited to surplus.\textsuperscript{136} The court distinguished \textit{Kirby Lumber} and simply treated this event as a reduction of the dividend.\textsuperscript{137} The Second Circuit stated that “it is not universally true that by discharging a liability for less than its face amount the debtor necessarily receives taxable gain.”\textsuperscript{138}

\textsuperscript{134} \textit{Id.}
\textsuperscript{135} \textit{Id.}
\textsuperscript{136} \textit{Id.}
\textsuperscript{137} \textit{Id.}
\textsuperscript{138} \textit{Id.; see also Zelenak, supra note 8, at 282.} Professor Zelenak, described the court’s reasoning with the following analysis:

Because the taxpayer received nothing of value when it issued the bonds as dividends … the overall transaction did not result in any economic gain or any taxable gain …. “In paying dividends to shareholders, the corporation does not buy property from them. Here the [taxpayer] never received any increment to its assets, either at the time the bonds were delivered or at the time they were retired.”

\textit{Id.} Professor Zelenak noted, however, that:

There is a split among the commentators who have considered whether the \textit{Rail Joint} court properly applied LP/MC [loan proceeds/mistake correction] analysis. The split is based on disagreement as to whether the taxpayer received anything of value when it distributed a dividend in the form of its own debt. Six commentators (including two co-authors) agree with the Second Circuit’s assumption that the taxpayer received nothing of value when it issued the bonds, and so agree with the court’s conclusion that the taxpayer had no COD income when it repurchased the bonds at a discount. Four other commentators (including two co-authors), however, claim that the Second Circuit was wrong, either because the bond dividend should be analogized to a sale of bonds to third parties for cash followed by the distribution of the cash proceeds to shareholders, or because a corporation should be understood as receiving a benefit analogous to a human being’s personal
Professors Chirelstein and Zelenak posited another fact pattern where utilizing different methodologies involving the determination of COD income could result in dissimilar outcomes. This example involved a pedestrian, negligently injured by an uninsured motorist, who received a $100,000 judgment. Because of difficulty in collecting, the pedestrian accepted $80,000, and gave up his claim to the remaining $20,000. Does the motorist have COD income? Under the freeing of assets approach he would have COD income; “his net worth increase[d] by $20,000 when liabilities decrease[d] by $100,000 while assets decrease[d] by only $80,000.” Under the loan proceeds approach, which they indicated “should be the sole theory of debt-cancellation income, ... the result [should be] that the $20,000 debt cancellation should not be taxed to the negligent motorist.” Presumably, under their version of the transactional approach, Professors Kahn and Kahn would also reach the result that there was no COD income.

There are other theories of when COD income should be determined to occur. Another approach, advocated by Professor James L. Musselman, was that:

when a taxpayer has received a discharge of indebtedness, it
must simply be determined whether such discharge resulted
in a clearly realized accession to the taxpayer's wealth, and in

consumption when it distributes value—including value in the
form of its own bonds—to its shareholders.

Id. at 299 (footnotes omitted). Professor Zelenak is of the opinion that while “[i]t is a close call ... [o]n balance, the argument in favor of COD income in the Rail Joint situation, based on the concept of dividends as the corporate analogue to personal consumption, should probably prevail.” Id. at 303.

139 CHIRELSTEIN & ZELENAK, supra note 27, at 62–63.
140 Id.
141 Id. at 63.
142 See id.
143 Id.
144 Id. at 63. Professor Zelenak expanded upon the negligent tortfeasor hypothetical in his Virginia Tax Review article. He wrote that “[t]he commentators who have considered this situation are in agreement that it produces no COD income under the LP/MC analysis, because the taxpayer received nothing of value when the debt arose.” Zelenak, supra note 8, at 313–14.
145 See Kahn & Kahn, supra note 3, at 166 (“If any part of the debt is forgiven, it then becomes clear that the assumption of a repayment of that part of the debt was mistaken.”).
what amount. ... [T]he amount of any such accession to wealth is determined by the value of anything the taxpayer received as a result of any such discharge of indebtedness, as with any other gross income issue. When determining the value received from the discharge of indebtedness, it is necessary to evaluate the transaction that initially created the indebtedness since any value the taxpayer received from a discharge of indebtedness would have been received at that time. Notably, the value received by the taxpayer at the time of the transaction initially creating the indebtedness would not have been included in the taxpayer’s gross income at that time because the receipt of such value coincided with the creation of the indebtedness by the taxpayer, thus resulting in no accession to the taxpayer’s wealth.\textsuperscript{146}

Professor Musselman acknowledged that his “proposal resembles, to an extent, the ‘loan proceeds theory’ [except that] ... [t]he ‘loan proceeds theory’ assumes that the taxpayer, in all cases in which he incurs an obligation, received value equal in amount to the obligation incurred.”\textsuperscript{147} Under Professor Musselman’s proposal “that assumption is inapplicable in [what he characterized as] appropriate situations.”\textsuperscript{148}

Professor Musselman discussed his proposed methodology with respect to an obligation for services, which is germane to Zarin.\textsuperscript{149} He posited an example wherein “a taxpayer agrees to pay an accountant $1,000 to prepare his tax return. After preparing and filing the return, the taxpayer is discharged from the $1,000 obligation.”\textsuperscript{150} While he indicated that the taxpayer would generally have $1,000 of COD income, “[i]f the taxpayer, in a case with appropriate facts, can show that he received value in a lesser amount than the debt incurred, he should not have income from the discharge of such debt in excess of the value received.”\textsuperscript{151}

One example of where the clarified loan proceeds methodology advocated by Professor Zelenak\textsuperscript{152} differs from Professor

\textsuperscript{146} Musselman, \textit{supra} note 6, at 632–33 (footnotes omitted).

\textsuperscript{147} \textit{Id}. at 633 n.160 (citations omitted).

\textsuperscript{148} \textit{Id}. (citation omitted).

\textsuperscript{149} See \textit{id}. at 635.

\textsuperscript{150} \textit{Id}. at 634–35.

\textsuperscript{151} \textit{Id}. at 635 (footnote omitted); Professor Musselman noted that Professor Dodge achieved a similar outcome under the latter’s belief that “the purchase-price adjustment doctrine exists outside of section 108(e)(5) ....” \textit{Id}. at 635 n.170 (citing Dodge, \textit{supra} note 19, at 682). This is discussed further below.

\textsuperscript{152} Professor Zelenak used the terminology “transactional accounting” and “whole-transaction analysis.” Zelenak, \textit{supra} note 8, at 280, 294.
Musselman’s proposed approach involved federal tax liabilities that are avoided due to a statute of limitations. For example, the taxpayer owed a certain amount of tax, e.g., $50,000 but the taxpayer “fails to pay the liability and for whatever reason, the statute of limitations for collecting such liability expires.” Under Professor Musselman’s methodology, there would be COD, because his “focus [was] on whether the taxpayer received anything of value when the obligation was created,” and he presumed a benefit from the government commensurate with the tax originally owed. He explained that “[t]ax obligations are imposed on taxpayers by operation of law ..., and all taxpayers receive some level of benefit as a result .... It makes good policy to presume that the value received is equal to the obligation imposed ....” Therefore it makes sense to “force gross income from discharge of indebtedness on taxpayers to the extent they are relieved of their obligations to pay their tax liabilities.” In contrast, Professor Zelenak asserted that “[b]ecause the taxpayer whose federal income tax liability is cancelled receives no benefit excluded from income by reason of the existence of the federal income tax liability, under the LP/MC analysis he should have no COD income from the cancellation.”

Finally, it is important to briefly examine the interplay between the judicial concepts and the Code with respect to COD income, which is important in examining Zarin. Professors McMahon and Simmons indicated that one must “[r]ecognize that section 61(a)(12) [now 61(a)(11)] and judicial precedents and section 108 provides overriding and supplemental rules.” They expressed their opinion that “because of the extensive detail in section 108, even when not expressly provided for by the statute, the Service and the courts tend to treat section 108 as providing the exclusive rules, supplanting prior judicial decisions with respect to issues that are addressed in the statutory provision.”

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153 See Musselman, supra note 6, at 654.
154 See id., see also Zelenak, supra note 8, at 316.
155 Musselman, supra note 6, at 654.
156 See id.
157 Id.
158 Id.
159 Zelenak, supra note 8, at 316.
160 McMahon & Simmons, supra note 3, at 425.
161 Id. at 425–26 (footnote omitted).
did, however, recognize that “[s]ome judicial exceptions nevertheless survive in cases not addressed by section 108.” Professor Dodge expressed a somewhat contradictory view when he wrote in the context of Zarin, “[t]he parameters of such income [i.e., COD income] are determined neither by § 108 nor the § 61 regulations, but rather by the evolving ‘common law’ of gross income.”

II. ZARIN V. COMMISSIONER

A. Facts & Tax Court Opinion

David Zarin and his wife, who filed jointly, were in Tax Court contesting a deficiency by the Service. This matter concerned an alleged $2.935 million of cancellation of indebtedness income in 1981 from the partial discharge of gambling loans received by Mr. Zarin. David Zarin “was a professional engineer involved in the development, construction, and management of various housing projects.” He was also a compulsive gambler, who by January 1980 “was gambling 12–16 hours per day, 7 days per week [and] was not aware of the amount of his gambling debts.”

While Zarin had gambled elsewhere, he began gambling at Resorts International Hotel, Inc. (Resorts) after New Jersey legalized casino gambling in Atlantic City, New Jersey. He applied for a $10,000 line of credit for gambling from Resorts on June 1978, which was approved despite some derogatory information. This was increased to $200,000 in November 1979 without a further

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162 Id. at 426 (footnote omitted).
163 Dodge, supra note 19, at 677–78.
165 Id. in the Third Circuit opinion, the court observed that the Service initially “determined deficiencies in Zarin’s federal income taxes for 1980 and 1981, arguing that Zarin recognized $3,435,000 of income in 1980 from larceny by trick and deception. After Zarin challenged that claim by filing a Tax Court petition, the Commissioner abandoned his 1980 claim ....” Id. at 112.
166 Id.
167 Id. at 1088.
170 Id.
credit check.\footnote{171} It was further increased to $215,000 in April 1980, again without an additional credit inquiry.\footnote{172}

Line of credit gamblers, such as Zarin, were “able to receive chips at the gambling table. Patrons of New Jersey casinos may not gamble with currency, but must use chips provided by the casino. Chips may not be used outside the casino where they were issued for any purpose.”\footnote{173} In order to obtain the chips Zarin signed “counter checks, commonly known as ‘markers.’ The markers were negotiable drafts payable to Resorts drawn on petitioner’s bank. The markers made no reference to chips, but stated that cash had been received.”\footnote{174} Zarin and the Resort’s credit manager agreed that his “markers would be held for the maximum period allowable under New Jersey law, which at that time was 90 days, whereupon [he] would redeem them with a personal check.”\footnote{175}

Zarin focused on playing mainly craps, and “usually bet the table limit,”\footnote{176} which was increased, at Zarin’s request, “to the house maximum.”\footnote{177} He became a Resorts “valued gaming patron”\footnote{178} and he and his guests received various complimentary perks including a luxurious suite, free meals and the use of a limousine.\footnote{179}

The Tax Court indicated that “[a]t all times pertinent hereto, [Zarin] intended to repay any credit amount properly extended to him by Resorts and to pay Resorts in full the amount of any personal check given by him to pay for chips or to reduce his gambling debt.”\footnote{180} In fact, he paid back to Resorts approximately $2.5 million incurred between June 1978 and June 1979.\footnote{181}

A complaint was filed in October 1979 by the New Jersey Division of Gaming Enforcement with the New Jersey Casino Control Commission alleging “809 violations pertaining to Resorts’ casino gaming credit system, its internal procedures, and its administrative and accounting controls[ ] ... [with] 100 [of those

\footnote{171} Id. at 1086.
\footnote{172} Id. at 1088.
\footnote{173} Id. at 1086.
\footnote{174} Id.
\footnote{175} Id. at 1086.
\footnote{176} Id. at 1085.
\footnote{177} Id. at 1086.
\footnote{178} Id.
\footnote{179} Id.
\footnote{180} Id. at 1086–87.
\footnote{181} Id. at 1087.
violations] specifically identified as pertaining to [Zarin] and a gambling companion."\textsuperscript{182} This resulted in the Casino Control Commission issuing an emergency cease and desist order that included the following:

\begin{quote}
Effective immediately, Resorts shall not issue credit to any patron whose patron credit reference card indicates that the credit now outstanding exceeds the properly approved credit limit. In determining whether a credit limit has been exceeded, all yet undeposited checks received in payment of a counter check or checks shall be included as credits.\textsuperscript{183}
\end{quote}

Resorts adopted a policy, put in place after the order was issued, that treated Zarin’s “personal checks as ‘considered cleared.’”\textsuperscript{184} As a result, Zarin’s personal checks were “treated as a cash transaction, and the amount of [each] check was not included in determining whether he had reached his permanent credit limit.”\textsuperscript{185} Furthermore, “Resorts extended petitioner’s credit limit by giving him temporary increases known as ‘this trip only’ credit.”\textsuperscript{186} The Tax Court pointed out that “[a]lthough not specifically addressed by the New Jersey Casino Control regulations in effect during 1979 and 1980, a ‘this trip only’ credit increase was a temporary credit increase for a patron’s current trip to Atlantic City, and was required to be reduced before the patron’s return.”\textsuperscript{187} The Tax Court observed that “[b]oth of these practices effectively ignored the emergency order.”\textsuperscript{188} In 1983, “Resorts was fined $130,000 for violating the Emergency Order on at least 13 different occasions, 9 of which pertained directly to credit transactions [with Zarin].”\textsuperscript{189}

According to the court, “[d]uring April 1980, petitioner delivered personal checks and markers in the total amount of $3,435,000 that were returned to Resorts as having been drawn against insufficient funds.”\textsuperscript{190} Zarin’s line of credit with Resorts
was cut off on April 29, 1980.\textsuperscript{191} Although Zarin told Resorts chief executive officer that he intended to repay the debt, he didn’t do so and in November 1980, “Resorts filed a complaint in New Jersey State Court seeking collection of $3,435,000 from [Zarin] based on the unpaid personal checks and markers.”\textsuperscript{192} Zarin did file an answer to the complaint, in which he denied “the allegations and assert[ed] a variety of affirmative defenses.”\textsuperscript{193} In September 1981 the lawsuit was settled with Zarin “agreeing to make a series of payments totaling $500,000.”\textsuperscript{194} The difference between this amount and original indebtedness of $3.435 million was the $2.935 million COD income in question before the Tax Court.\textsuperscript{195}

Sitting en banc, the Tax Court held that Zarin had COD income as a result of the settlement with Resorts, although the Tax Court judges were divided on this question eleven to eight.\textsuperscript{196} In reaching this result the court rejected the taxpayer’s assertions that there should be no COD income because: 1) “the debt instruments were not enforceable under New Jersey law”;\textsuperscript{197} 2) “gambling and debts incurred to acquire gambling opportunity have always received special treatment at common law and in the Internal Revenue Code”;\textsuperscript{198} 3) the settlement constituted a purchase-money debt reduction that was excluded from gross income pursuant to section 108(e)(5);\textsuperscript{199} 4) finding for the Service “would result in taxing petitioner on his losses”;\textsuperscript{200} 5) “settlement of disputed debts does not give rise to income;”\textsuperscript{201} and 6) “any income from discharge of his gambling debt was income from gambling against which he may offset his losses.”\textsuperscript{202}

The court first determined that the burden of proof was on the Service.\textsuperscript{203} The court reasoned that the issue was “a new
matter,” since the Service was now asserting the deficiency based on COD income for 1981 which “clearly requires different evidence from the ground originally asserted in the notice of deficiency, that the income was received in 1980 from larceny by trick and deception.” As such, the court indicated that because the Service “bears the burden of proof, [it] can prevail only if the stipulated facts support a conclusion that a discharge of indebtedness occurred that resulted in taxable income under the law.”

The Tax Court noted that while the general rule in the Code is that “gross income includes all income from whatever source derived, including income from the discharge of indebtedness[,] ... not all discharges of indebtedness, however, result in income.” As to the latter point, the court quoted from the applicable regulations that “[t]he discharge of indebtedness, in whole or in part, may result in the realization of income.”

At least initially, the Tax Court seemingly embraced the “freeing of assets” theory, observing that “[t]he gain to the debtor from such discharge is the resultant freeing up of his assets that he would otherwise have been required to use to pay the debt.” The court’s reasoning later, however, altered to more of a loan replacement approach. This included the statement concluding

the taxpayer did receive value at the time he incurred the debt and that only his promise to repay the value received prevented taxation of the value received at the time of the credit transaction. When, in the subsequent year, a portion of the obligation to repay was forgiven ... [this caused section 61(a)(12) to apply].

As discussed below, this loan proceeds approach was also evidenced by the discussion of Tufts and its requirement for symmetry. It should be observed that the taxpayer in arguing that he had no COD income because the obligation was unenforceable, asserted

204 Id. at 1089.
205 Id.
206 Id. at 1090.
207 Id. at 1089 (citing I.R.C. § 61(a)(12) (currently I.R.C. §§ 61(a)(11), 1.61-12(a)).
208 Id. (citing Reg. § 1.61-12(a)) (emphasis in opinion).
209 Id. (citing United States v. Kirby Lumber Co., 284 U.S. 1 (1931)).
210 See id. at 1094.
211 Id. at 1094.
212 See supra note 85 and accompanying text.
that under the freeing of assets theory “[its] discharge ... had no effect whatsoever on his net worth and could [thus] not result in debt discharge income.”

As noted, Zarin cited Hall in support of his position that gambling debts are treated differently from other obligations. While Hall was not found to be compelling precedent by the Tax Court, the Third Circuit disagreed. In Hall, “the taxpayer transferred appreciated property in satisfaction of a gambling debt of an undetermined amount incurred in Las Vegas, Nevada. The Commissioner sought to tax as gain the difference between the amount of the discharged debt and the basis of the appreciated property.” Gambling debts were unenforceable in Nevada.

The Tenth Circuit stated in Hall that “[t]he general rules relied upon by the government as having application to gain realized from cancellation of debt, sound as such rules may be in the ordinary course of business affairs, are but artificial theory when applied to the facts of the case at bar.” Furthermore, it stated “Congress has recognized that gain and loss from gambling requires special treatment within the tax structure ... [and that] a gambling debt ... does not meet the requirements of debt necessary to justify the mechanical operation of general rules of tax law relating to cancellation of debt.” The Tenth Circuit also indicated that “[t]he cold fact is that taxpayer suffered a substantial loss from gambling” and “conclude[d] that under the circumstances of the case” that taxpayer did not have taxable income.

The Zarin Tax Court dispensed with Hall by tying the decision to Kerbaugh-Empire, perhaps questionably, at least according to the Third Circuit in Zarin. The Tax Court pointed out that

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214 Zarin, 92 T.C. at 1090.
216 Zarin, 92 T.C. at 1091.
217 Id.
219 Id. (citations omitted).
220 Id.
221 Id. at 242.
222 Id. As discussed infra, the Third Circuit believed that Hall’s reliance on Kerbaugh-Empire was limited to “the proposition that ‘a court need not in every case be oblivious to the net effect of the entire transaction.’” Zarin, 916
the Tenth Circuit in Hall, “relied on the so-called ‘diminution of loss theory’ developed by the Supreme Court in Bowers v. Kerbaugh-Empire ....”\footnote{Zarin v. Comm’r, 92 T.C. 1084, 1091 (1989)} The Tax Court explained that in Kerbaugh-Empire, “the taxpayer borrowed money that was subsequently lost in a business transaction. The debt was satisfied for less than its face amount. The Supreme Court held that the taxpayer was not required to recognize income from discharge of a debt because the transaction as a whole lost money.”\footnote{Id.}

The Tax Court in Zarin pointed out that Kerbaugh-Empire “has lost its vitality.”\footnote{Id.} It cited Vukasovich, Inc. v. Commissioner,\footnote{Vukasovich, Inc. v. Comm’r, 790 F.2d 1409 (9th Cir. 1986).} wherein the Ninth Circuit concluded that “the principles of Kerbaugh-Empire had been rejected by the Supreme Court in the subsequent cases ... even though the 1926 case had not been specifically overruled ....”\footnote{Zarin, 92 T.C. at 1093.}

In terms of the enforceability of the obligation in New Jersey, the court stated that the “[l]egal enforceability of an obligation to repay is not determinative of whether the receipt of money or property is taxable .... The enforceability of petitioner’s debts under New Jersey law did not affect either the timing or the amount and thus is not determinative for federal income tax purposes.”\footnote{Id. at 1094, 1095.} It thus ignored the fact that in Hall, the Tenth Circuit, indicated that “a gambling debt [is] unenforceable in every state,”\footnote{United States v. Hall, 307 F.2d 238, 241 (10th Cir. 1962).} which may have factored in the Tenth Circuit reaching its decision.\footnote{See id. at 242.}

Very importantly, the Tax Court also cited and discussed Commissioner v. Tufts, holding that “upon sale of mortgaged property, the seller–original borrower must include the amount of the nonrecourse mortgage assumed by the purchaser in calculating the amount realized from sale, even when the fair market

\textsuperscript{223} Zarin v. Comm’r, 92 T.C. 1084, 1091 (1989)  
\textsuperscript{224} Id.  
\textsuperscript{225} Id.  
\textsuperscript{226} Vukasovich, Inc. v. Comm’r, 790 F.2d 1409 (9th Cir. 1986).  
\textsuperscript{227} Zarin, 92 T.C. at 1093.  
\textsuperscript{228} Id. at 1094, 1095.  
\textsuperscript{229} United States v. Hall, 307 F.2d 238, 241 (10th Cir. 1962).  
\textsuperscript{230} See id. at 242.
value of the property is less than the outstanding amount of the nonrecourse obligation.” The Tax Court stressed that the *Tufts* rationale was based on symmetry:

> [T]hat the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay .... Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property ....

The Tax Court then indicated that

symmetry from year to year is not accomplished unless we treat petitioner’s receipt of the loan from Resorts ... and the subsequent discharge of his obligation to repay that loan in a consistent manner. [Zarin] received credit of $3,435,000 from Resorts. He treated these amounts as a loan, not reporting any income on his 1980 tax return.

The Tax Court also rejected the notion that due to the precedent of *Kerbaugh-Empire*, Zarin’s loss of the loan proceeds should have shielded him from COD income. The Tax Court also declared that “[w]e are not persuaded that gambling debts should be accorded any special treatment for the benefit of the gambler—compulsive or not.”

The Tax Court similarly denied application of the contested liability/disputed debt exception to COD income that was recognized by the Board of Tax Appeals in *N. Sobel, Inc. v. Commissioner*, a case cited by the taxpayer. By way of background, where applicable, the contested liability (also known as disputed debt) doctrine provides that “settlement of a claim does not result in realization of [COD] income if there is a bona fide dispute regarding the

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231 *Zarin*, 92 T.C. at 1092. The taxable income in *Tufts*, however, was not determined under § 61(a)(11).
232 *Id.* (citing United States v. *Tufts*, 461 U.S. 300, 309–10 (1983)).
233 *Id.*
234 *Id.* at 1093–94.
235 *Id.* at 1095.
debtor's liability for the amount claimed by the creditor.”238 Some scholars including Professors Kahn & Kahn, however, are of the view that “there is either no contested liability exclusion [to COD] income or there should not be.”239

With reasoning similar to a later decision, Preslar v. Commissioner,240 discussed infra, the Tax Court stated that “[p]rior to the settlement, the amount of petitioner’s gambling debt to Resorts was a liquidated amount, unlike the taxpayer’s debt in Hall.”241 Zarin had “at the time the debt was created ... agreed and intended to repay the full amount ... he received full value for what he agreed to pay, i.e., over $3 million worth of chips and the benefits received by petitioner as a ‘valued gambling patron’ of Resorts.”242 Furthermore, the Tax Court asserted, “[t]here is no dispute about the amount petitioner received .... A genuine dispute does not exist merely because petitioner required Resorts to sue him before making payment of any amount on the debt.”243 Thus, even though Resorts apparently had concerns about the debt's enforceability, which could be at least one of the reasons it agreed to a heavily discounted $500,000 settlement, the Tax Court, believed it did not come within a disputed debt exception to recognizing COD income.244 Thus N. Sobel and the contested liability (disputed debt) doctrine were found to be inapplicable.245

N. Sobel was referred to by the Third Circuit in Zarin, as “[t]he seminal ‘contested liability’ case.”246 The decision concerned a taxpayer, who was a dealer in fur skins and had bought stock in a bank, which he had done business with for many years.247 The shares were paid for with a promissory note.248 The purchase was precipitated by “a campaign to sell the bank’s stock ....”249 The note

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238 See McMahon & Simmons, supra note 3, at 435 (footnote omitted).
239 See Kahn & Kahn, supra note 3, at 206.
240 167 F.3d 1323, 1328 (10th Cir. 1999) rev’g & rem’g TC Memo 1996-543 (1996).
241 Zarin, 92 T.C. at 1095.
242 Id. at 1096.
243 Id. at 1095–96.
244 Id. at 1096.
245 Id.
246 Zarin v. Comm’r, 916 F.2d 110, 115 (3d Cr. 1990)
248 Id. at 1264.
249 Id. at 1263.
was never paid, and instead the taxpayer “instituted suit against the bank, demanding rescission of the purchase contract and the loan and a judgment for the interest paid, on the ground that the bank made the loan in violation of law and failed to carry out promises to guarantee the purchaser against loss.”\textsuperscript{250} The bank was closed because of insolvency and a countersuit was brought against the taxpayer by the Superintendent of Banks of the State of New York.\textsuperscript{251} The lawsuits were settled with the taxpayer paying half of the note.\textsuperscript{252} The Service’s assertion that the remaining balance of the note was taxable to the company was rejected by the court, which indicated “that the release of the note was not the occasion for a freeing of assets and that there was no gain under the doctrine of \textit{Kirby Lumber Co. v. United States} ....”\textsuperscript{253} As will be discussed, the Tenth Circuit in \textit{Preslar} distinguished \textit{N. Sobel} and found the contested liability/disputed debt doctrine inapplicable in case involving a liquidated debt obligation.\textsuperscript{254}

With respect to the taxpayer’s assertion that he should be able to offset any COD income with gambling losses, the Tax Court responded that neither section 165 nor the regulations thereunder permit such treatment.\textsuperscript{255} The court stated that Zarin “incurred gambling losses in 1980, but his gain from the discharge of his gambling debts occurred in 1981. That gain is separate and apart from the losses he incurred from his actual wagering transactions.”\textsuperscript{256}

As to Zarin’s contention that the settlement with Resorts should be treated as a “purchase-money debt reduction,”\textsuperscript{257} and as such, he was not taxable pursuant to section 108(e)(5), the Tax Court was equally dismissive.\textsuperscript{258} It stated “that the value received by petitioner in exchange for the credit extended by Resorts does not constitute the type of property to which section 108(e)(5) was intended to or reasonably can be applied.”\textsuperscript{259}

\begin{footnotesize}
\textsuperscript{250} \textit{Id.} at 1264.
\textsuperscript{251} \textit{Id.}
\textsuperscript{252} \textit{Id.}
\textsuperscript{253} \textit{Id.} at 1265.
\textsuperscript{254} \textit{Preslar v. Comm’r}, 167 F.3d 1323, 1327–28 (10th Cir. 1999).
\textsuperscript{256} \textit{Id.}
\textsuperscript{257} \textit{Id.} at 1097.
\textsuperscript{258} \textit{Id.} at 1098.
\textsuperscript{259} \textit{Id.}
\end{footnotesize}
provides for an exception to COD income for solvent debtors for a reduction in debt that arose from the purchase of property.260

The Tax Court, citing the provision’s legislative history, explained that “section 108(e)(5) was enacted ‘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.’”261 The court reasoned Zarin didn’t satisfy the statutory requirement of the debt’s connection to the purchase of property in “that what he received was something other than normal commercial property .... The ‘property’ argument simply overemphasizes the significance of the chips. As a matter of substance, chips in isolation are not what petitioner purchased.”262 Instead, the Tax Court determined Zarin obtained an “opportunity to gamble.”263 The chips “were a medium of exchange within the Resorts casino, and in that sense, they were a substitute for cash, just as Federal Reserve Notes, checks, or other convenient means of representing credit balances constitute or substitute for cash.”264 The chips Zarin received simply were not the “normal commercial property,”265 to which section 108(e)(5) was intended to apply to.266 As discussed infra, Judge Stapleton, in his Third Circuit dissenting opinion, raised an alternative ground for why the section was not appropriate in Zarin; the section can only function when the taxpayer still holds the property in question when the settlement occurred.267 Thus, even if the gambling chips constituted the type of property that section 108(e)(5) was intended to cover, Zarin did not possess them at settlement, which eliminated the basis reduction quid pro quo intended by Congress.268

260 Id. at 1097.
262 Id. at 1099.
263 Id.
264 Id. at 1100.
265 Id. at 1099.
267 Zarin v. Comm’r, 916 F.2d 110, 118 n.3 (3d Cr. 1990) (Stapleton, J., dissenting).
Judge Tannenwald made it clear at the beginning of his dissenting opinion that it was “unnecessary to rely on Kerbaugh-Empire.”\(^{269}\) Instead, he observed that Zarin is unlike all other decisions involving COD income wherein “the taxpayer had, in a prior year when the indebtedness was created, received a non-taxable benefit clearly measurable in monetary terms which would remain untaxed if the subsequent cancellation of the indebtedness were held to be tax free.”\(^ {270}\) While this reference seems to apply the loan proceeds approach, like the majority opinion the methodology utilized was not consistent. Later in the opinion he referred to the “freeing of assets” theory when he wrote that, “I think it significant that because the debts involved herein were unenforceable \textit{from the moment that they were created}, there was no freeing up of petitioners’ assets when they were discharged ... and therefore there was no increase in petitioners’ wealth that could constitute income.”\(^ {271}\) He also referred to a “freeing of asset approach” in conjunction with the discussion of \textit{Kerbaugh-Empire}.\(^ {272}\)

His view was apparently that Zarin didn’t receive the functional equivalent of $3.435 million from Resorts.\(^ {273}\) In a footnote, he remarks that “I think it clear that, although theoretically the chips could have been redeemed for cash instead of being used for gambling, any attempt by Mr. Zarin to follow this path would have been known to Resorts’ personnel and strongly resisted.”\(^ {274}\) What if Zarin, not implausibly, got help with his addiction, and decided it was time to cash in his chips? Would Zarin, an educated engineer and successful businessman, undoubtedly familiar with capable lawyers, not be able to do so? This assertion by Judge Tannenwald was certainly questionable.

Judge Tannenwald also remarked that “[t]he concept that petitioner received his money’s worth from the enjoyment of using the chips (thus equating the pleasure of gambling with increase in wealth) produces the incongruous result that the more a gambler loses, the greater his pleasure and the larger the increase in

\(^{269}\) Zarin, 92 T.C. at 1101 (Tannenwald, J., dissenting). He does however note “that it does not follow from ‘the freeing of asset’ approach ... that Kerbaugh-Empire is moribund for all purposes.” \textit{Id.}
\(^{270}\) \textit{Id.}
\(^{271}\) \textit{Id.} at 1103 (citation omitted).
\(^{272}\) \textit{Id.} at 1101.
\(^{273}\) \textit{Id.}
\(^{274}\) \textit{Id.} at 1101 n.1.
Professor Babette B. Barton provided a very astute response, stating that

[t]he fact is, however, that a similar incongruity tends to take shape whenever losses suffered by a debtor motivate the creditor to excuse the debtor’s obligation .... The size of the canceled debt ... bears a positive correlation to increased losses of the debtor. A less than economically-thriving debtor seems the most likely candidate of COD income.276

Judge Tannenwald also argued that the debt was unenforceable in New Jersey,277 and as such, the fact that Zarin “intended to repay the full amount at the time the debt was created is ... irrelevant.”278 He rejected the significance of Flamingo Resorts, Inc. v. United States,279 a case cited by the Service and Tax Court majority, which held “that unenforceability under Nevada law did not nullify the ‘all events test,’ so as to avoid accruability by a casino of accounts receivables ... from gambling patrons.”280 He asserted that the case was predicated on the fact that there was “reasonable expectancy of collection,” which was not the case with Zarin.281

He believed it “obvious that Mr. Zarin would resist any attempt to collect[ which was demonstrated by t]he fact that such resistance actually occurred ....”282 Another distinction he contended, which is certainly valid, is that Flamingo Resort “dealt with the accruability of income to the casino; here the issue is the existence of income when a gambling debt is discharged.”283

Judge Tannenwald also thought the contested liability doctrine relevant.284 He asserted that “I do not read ... language [in N. Sobel and elsewhere] as requiring that Kirby Lumber

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275 Id. at 1101 (footnote omitted).
276 Barton, supra note 168, at 770.
277 Zarin, 92 T.C. at 1101–03 (Tannenwald, J., dissenting).
278 Id. at 1101.
279 Flamingo Resort, Inc. v. United States, 664 F.2d 1387, 1390–91 (9th Cir. 1982).
280 Zarin, 92 T.C. at 1102 (Tannenwald, J., dissenting).
281 Id. at 1102–03.
282 Id.
283 Id.
284 Id. at 1104.
must apply unless the amount is unliquidated, where there is a
genuine dispute as to the underlying liability.”\footnote{285}

Professor Seto, whose perspective was that of being one of
Zarin’s lawyers for the Third Circuit appeal,\footnote{286} was relatively
positive regarding Judge Tannenwald’s dissent.\footnote{287} While he ac-
nowledged that “Tannenwald’s analysis can be criticized as
technically inadequate[ ] ... [and] that [it] did not offer a sophis-
ticated technical resolution of any of the difficult issues the case
raised,”\footnote{288} Professor Seto defended Judge Tannenwald for “ap-
pealing to common sense ....”\footnote{289} This included, according to Pro-
fessor Seto, Judge Tannenwald’s being troubled with “the
incongruous result that the more a gambler loses, the greater
his pleasure and the larger the increase in his wealth.”\footnote{291} Pro-
fessor Seto was comfortable with Judge “Tannenwald ... rely[ing]
on the traditional rule that debt must be enforceable to be ‘debt’
and on a simple interpretation of the disputed debt exception to
justify his conclusion that Zarin did not recognize discharge of
indebtedness income in 1981.”\footnote{292} As discussed further
infra, this writer does not share the opinion of Professors Seto, Zelenak
and some other commentators that essentially Judge Tannenwald got
it right in Zarin.\footnote{293}

Judge Jacobs noted in his separate dissenting opinion that
the obligation to Resorts was invalid and unenforceable.\footnote{294} As a
result, he would hold it to be “void ab initio, and therefore, ...
[Zarin] realized income ... in 1980 ... to the extent of the value of

\footnotetext{285}{Id.}
\footnotetext{286}{See Seto, supra note 213, at 1764.}
\footnotetext{287}{See id. at 1786.}
\footnotetext{288}{Id.}
\footnotetext{289}{Id. at 1785.}
\footnotetext{290}{Id.}
\footnotetext{291}{Zarin v. Comm’r, 92 T.C. 1084, 1101 (1989) (Tannenwald, J., dissenting).}
\footnotetext{292}{See Seto, supra note 213, at 1785–86. Professor Seto was critical of the
Tax Court opinion writing that “[t]he majority’s conclusions that a discharge of
unenforceable gambling debt was taxable and that the disputed debt exception
only applied to unliquidated debt were both contrary to precedent—albeit skimpy
precedent. Its reading of § 108(e)(5), as Judge Ruwe’s dissenting opinion
would demonstrate, violated conventional canons of statutory construction.”
Id. at 1777.}
\footnotetext{293}{See supra notes 106–07.}
\footnotetext{294}{Zarin, 92 T.C. at 1105 (Jacobs, J., dissenting).}
the chips received.” Professor Seto was critical of this approach because pursuant to *James v. United States*, a taxpayer may be charged with income on the receipt of funds if and only if he received those funds ‘without the consensual recognition, express or implied, of an obligation to repay.” Professor Seto also pointed out that this standard applies “regardless of whether the obligation was enforceable.”

Judge Jacobs’s analysis from this point became even more problematic. First, he “[would] hold that the amount of petitioner’s losses from wagering activities in 1980 equaled or exceeded the amount of chip income. [i.e., the $3.435 million of gambling credit Zarin received in 1980 from Resorts, without an enforceable obligation to repay.]” Despite recognizing that section 165(d) by its terms “limits losses from wagering transactions to the extent of gains,” he found the provision germane. Judge Jacobs’s justification was that “the chip income constitutes gain from a wagering transaction, because no such income would have been realized but for the wagering transactions in which petitioner’s losses occurred.”

Judge Jacobs also criticized the Tax Court majority opinion for determining Zarin had COD income in 1981, stating that “[f]or interest on indebtedness to be deductible under section 163, it is well recognized that the indebtedness must be enforceable. ... [The same rule should apply to] the inclusion of discharge of indebtedness income.” He simply ignored the fact that the provisions regarding what is included in gross income and what is deductible are often not symmetrical. Finally, he seemed to hint at a Kerbaugh-Empire rationale when he quoted from *Hall* that “[i]n deciding the income tax effects of cancellation of

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295 *Id.* at 1105–06.
297 See Seto, supra note 213, at 1786 (citing *James*, 366 U.S. at 219). Professor Seto also pointed out that this standard applies “regardless of whether the obligation was enforceable.” *Id.* (citing Liddy v. Comm’r, 808 F.2d 312,314 (4th Cir. 1986)). Professor Seto had other issues with Judge Jacobs’s approach including its impossibility to administer. *Id.*
298 See *id.* at 1786–87.
299 *Zarin*, 92 T.C. at 1106 (Jacobs, J., dissenting).
300 *Id.*
301 *Id.*
302 *Id.*
303 *Id.* at 1106–07.
indebtedness for less than its face amount, a court need not in every case be oblivious to the net effect of the entire transaction.”

Judge Ruwe’s dissent, which four other judges joined, focused on their view that section 108(e)(5) was applicable. One commentator indicated that his dissent “from a purely technical standpoint[ was] probably the best legal argument applied to the Zarin facts,” although, this writer believes section 108(e)(5) was improper for Zarin on two separate grounds mentioned above and elaborated on infra, and neither court found the section relevant.

Judge Ruwe acknowledged that apart from the question of section 108(e)(5)’s applicability, he “agree[d] with much of the majority’s reasoning ....” He argued that “[t]he parties stipulated that the chips were ‘property[’] ... [and that it] is beyond question that gambling chips constitute what is commonly referred to as property.” He took issue with “[t]he majority’s legal conclusion [that] seems to be that gambling chips, being other than ‘normal commercial property’ [in their judgment], do not constitute ‘property’ within the meaning of section 108(e)(5).” Judge Ruwe asserted that with respect to section 108(e)(5), “neither the statute nor the accompanying legislative history qualify or restrict the term ‘property.’ No attempt has been made to specify any limits on the scope of the term. Instead, the term is used in a broad, comprehensive manner.” He was (in this writer’s opinion incorrectly) derisive of the Service’s position that “[a] purchase price adjustment [under 108(e)(5)] occurs when the dispute involves contract liability for the purchase of

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304 Id. at 1107 (citing United States v. Hall, 307 F.2d 238, 242 (10th Cir. 1962)).
305 Id. at 1107–16 (Ruwe, J. dissenting).
306 Jon D. Rigney, Zarin v. Commissioner: The Continuing Validity of Case Law Exceptions to Discharge of Indebtedness Income, 28 SAN DIEGO L. REV. 981, 990 (1991). He did, however, acknowledge that “[t]here are ... sound policy considerations, explored in the analysis of the Third Circuit opinion, for not applying the argument [that section 108(e)(5) excluded the debt discharge from gross income.]” Id. at 990 n.72.
307 See id. at 990–94; supra notes 62–64 and accompanying text; infra Section II.E.
308 Zarin, 92 T.C. at 1107 (Ruwe, J., dissenting).
309 Id. at 1108.
310 Id.
311 Id. at 1111.
an asset.”\textsuperscript{312} He wrote that “I am unable to discern any basis or rationale for this argument.”\textsuperscript{313}

He concluded that:

The majority decides an issue of first impression by disregarding the plain language of the statute without any justification in the statute or legislative history .... I would dispose of this case by assuming that there was discharge of indebtedness income. I would then apply section 108(e)(5) to treat the discharge as a purchase price adjustment.\textsuperscript{314}

After losing in Tax Court, Zarin fired his lawyers from Reid & Priest and retained new counsel at Caplin & Drysdale, which filed for a rehearing at Tax Court.\textsuperscript{315} The grounds for the rehearing motion were primarily based on Zarin being exempt under the insolvency exception to section 108, section 108(a)(1)(B), although his original counsel had conceded he was solvent.\textsuperscript{316} When the motion was denied,\textsuperscript{317} Zarin changed lawyers once again for his appeal to the Third Circuit.\textsuperscript{318} This time, with lawyers from Drinker & Biddle, he hit the jackpot, but did lose the dice roll in a malpractice suit he filed against Reid & Priest.\textsuperscript{319}

B. Third Circuit Opinion

The Third Circuit reversed the Tax Court and held for the taxpayer.\textsuperscript{320} Professor Seto observed that “[i]n substance, the Third Circuit majority opinion mirrored Tannenwald’s; it held, in effect, that Zarin had not received $3.435 million in value and that the discharge was exempt because Zarin’s debt was unenforceable and disputed.”\textsuperscript{321} While many, but not all, pundits applaud the outcome, the court’s opinion has been subject to sharp

\textsuperscript{312} \textit{Id.} at 1115.
\textsuperscript{313} \textit{Id.}
\textsuperscript{314} \textit{Id.} at 1115–16.
\textsuperscript{315} \textit{See} Schenk, \textit{supra} note 12, at 167 n.21.
\textsuperscript{316} \textit{See} Seto, \textit{supra} note 213, at 1791.
\textsuperscript{317} Zarin v. Comm’r, 916 F.2d 110, 112 n.6 (3d Cir. 1990).
\textsuperscript{318} \textit{See} Schenk, \textit{supra} note 12, at 167 n.91.
\textsuperscript{319} \textit{Id.}
\textsuperscript{320} Zarin, 916 F.2d at 117.
\textsuperscript{321} Seto, \textit{supra} note 213, at 1791.
rebuke. This writer is critical of the Third Circuit’s reasoning as well as its conclusion. Essentially, the Third Circuit held that Zarin was not subject to tax for two reasons, either of which (according to the Third Circuit) would have served to nullify COD income. First, Section 108(d)(1)'s definition of the term “indebtedness of the taxpayer” was not satisfied, therefor “the cancelation of indebtedness provisions of the Code [did] not apply to the settlement between Resorts and Zarin.” Second, the contested liability (disputed debt) doctrine was applicable because the debt was determined to be unenforceable.

The Circuit Court initially determined “that sections 108 and 61(a)(12) were inapplicable ....” In reaching these findings, the court indicated that it looked to section 108(d)(1) as to what indebtedness meant in section 61(a)(12) because the term was not defined in section 61. Having done so, the court stated that “[i]n order to come within the sweep of the discharge of indebtedness rules, ... the [taxpayer] must show that one of the two prongs in the section 108(d)(1) test is satisfied. Zarin satisfies neither.”

Section 108(d)(1) provides that “[f]or purposes of this section, the term ‘indebtedness of the taxpayer’ means any indebtedness—(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property.” The court then focused on the first of the alternatives for “indebtedness of the taxpayer” and found that “[b]ecause the debt Zarin owed to Resorts was unenforceable as a matter of New Jersey state law, it is clearly not a debt ‘for which the taxpayer is liable.’” While, as explained in Judge Stapleton’s dissent, this determination should only be academic,

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322 See, e.g., Shaviro, supra note 11, at 258. That “[g]iven the serious problems with the Third Circuit’s reasoning, one fervently hopes that it will fail to live on as precedent for any broad proposition of tax law.” Id.
323 Zarin, 916 F.2d at 114.
324 Id.
325 Id. at 113.
326 Id.
327 Id.
328 I.R.C. § 108(d)(1).
329 Zarin, 916 F.2d at 113 (footnote omitted). In an accompanying footnote, the Third Circuit noted, in part, that “[t]he Tax Court held that the Commissioner had not met its burden of proving that the debt owed Resorts was enforceable as a matter of state law .... There was ample evidence to support the finding.” Id. at 113 n.7.
this writer believes it was in error. Professor Babette B. Barton observed that “[t]he correctness of this interpretation is at the least questionable in light of the Supreme Court’s expressed attitudes about the immateriality for tax purposes of whether a debtor is or is not personally liable for a debt.”330 Professor Musselman characterized the court’s analysis here as “most surely incorrect.”331

As to the alternative definition of “indebtedness of the taxpayer” under section 108(d)(1)(B), the court found that “Zarin did not have a debt subject to which he held property as required by section 108(d)(1)(B).”332 In doing so, as noted above, the court implicitly rejected Judge Ruwe’s argument in dissent and endorsed the Tax Court finding “that gambling chips were not property, but rather, ‘a medium of exchange within the Resorts casino’ and a ‘substitute for cash.’”333 That is, “the chips [are] nothing more than ‘the opportunity to gamble ....’”334 The court further buttressed its conclusion that the chips should not be regarded as property for purposes of section 108(d)(1)(B) by asserting that “[e]ven were there no relevant legislative pronouncement [referring to a New Jersey statute referenced above] on which to rely, simple common sense would lead to the conclusion that chips were not property in Zarin’s hands.”335 The court pointed out that “Zarin could not do with the chips as he pleased, nor did the chips have any independent economic value beyond the casino. The chips themselves were of little use to Zarin, other than as a means of facilitating gambling.”336 While not addressed by the Third Circuit, even if the gambling chips constituted property within the meaning of the statutory provision (which this writer

330 Barton, supra note 168, at 754–55 (footnote omitted).
331 Musselman, supra note 6, at 617 (footnote omitted).
332 Zarin, 916 F.2d at 113.
333 Id.
334 Id. The Third Circuit embellished its argument by citing a New Jersey statute that provided that “gaming chips in New Jersey during 1980 were regarded ‘solely as evidence of a debt owed to their custodian by the casino licensee and shall be considered at no time the property of anyone other than the casino licensee issuing them.” Id. at 114 (citing N.J. Admin. Code tit. 19k, § 19:46-1.5(d) (1990)).
335 Id.
336 Id.
believes would have been incorrect), the taxpayer would not satisfy the requirement in section 108(d)(1)(B) that the taxpayer “holds property.”\footnote{I.R.C. § 108(d)(1)(B) (emphasis added).} The chips were gone when Zarin settled.\footnote{Zarin, 916 F.2d at 112, rev’g 92 T.C. 1084 (1989).} Judge Stapleton’s observation, in his dissenting opinion that “[s]ection 108(d) expressly defines that term solely for purposes of § 108 and not for purposes of § 61(a)(12),”\footnote{Id. at 118 n.3 (Stapleton, J., dissenting).} should make the foregoing analysis moot, i.e., even if met, the requirements of section 108(d)(1)(A) (which this writer and many scholars believe he had) or section 108(d)(1)(B) (which it is fairly clear he did not), this should not mean he had COD income. Conversely, a failure to meet both requirements should not have served to relieve him of COD income.

A major focus of the Third Circuit opinion was on the Tax Court’s determination that the debt was unenforceable.\footnote{Id. at 113.} It was critical to the Third Circuit’s finding, albeit mistaken, that section 108(d)(1)(A) was inapplicable.\footnote{Id.} The Third Circuit also decided that the contested liability doctrine was relevant because the debt was deemed to be unenforceable.\footnote{Id. at 115.} The Tax Court was correct in determining that lack of enforceability of the debt does not serve to shield COD income.\footnote{Zarin v. Comm’r, 92 T.C. 1084, 1094–95 (1989).} As Professor Shaviro observed “[t]he lack of legal enforceability hardly seems relevant here.”\footnote{See Shaviro, supra note 11, at 243.} The focus of the Third Circuit “should [have been] whether the parties intended to create a debt.”\footnote{Douglas E. Kulper, Taxpayer Rolls the Dice and the IRS Craps out: Forgiveness of Gambling Debts is Not Income in Zarin v. Commissioner, 1991 UTAH L. REV. 617, 636 (1991).} As discussed below, the post-Zarin Tenth Circuit decision in Preslar supported this view that “[e]nforceability of the debt ... should not affect the tax treatment of the transaction.”\footnote{Preslar v. Comm’r, 167 F.3d 1323, 1329 (10th Cir. 1999), rev’g & rem’g TC Memo 1996-543 (1996).} In fixating on the enforceability rabbit hole, the Third Circuit failed to focus on some key
Tax Court findings about the genuine debtor-creditor relationship Zarin had with Resorts. This included that the Tax Court determined that “[a]t all times pertinent hereto [presumably up to the time of Resorts’ lawsuit], petitioner intended to ... pay Resorts in full ....” Furthermore, there was no indication that when Resorts extended Zarin’s credit, it did not expect to be repaid. In fact, Zarin had previously paid in full gambling debts to Resorts of $2.5 million.

With respect to its alternative grounds for finding Zarin did not have COD income, i.e., the use of the contested liability (also known as disputed debt) doctrine, the Third Circuit explained that “[u]nder the contested liability doctrine, if a taxpayer, in good faith, disputed the amount of a debt, a subsequent settlement of the dispute would be treated as the amount of debt cognizable for tax purposes.”

The Third Circuit opinion rejected the Service’s and Tax Court’s position that the contested liability doctrine has no application to the case at bar because “Zarin’s debt was liquidated ....” The Third Circuit’s position was that “[w]hen a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute.” Furthermore, the court stated that “[the] dollar value to each chip ... is not beyond dispute ....” The court contended that “[i]f indeed the only issue was the enforceability of the entire debt there would have been no settlement .... Such a debt cannot be called liquidated, since its exact amount was not fixed until settlement.” The court’s position was subject to strong criticism by the Tenth Circuit in Preslar for failure to distinguish a liquid debt obligation from an illiquid one.

347 Zarin, 92 T.C. at 1086.
348 Id.
349 Id. at 1087.
351 Id. at 116.
352 Id.
353 Id.
354 Id.
The Third Circuit’s position on the application of the contested liability doctrine to Zarin was also undercut by a fallacious example offered by the court:

Thus, if a taxpayer took out a loan for $10,000, refused in good faith to pay the full $10,000 back, and then reached an agreement with the lender that he would pay back only $7,000 in full satisfaction of the debt, the transaction would be treated as if the initial loan was $7,000. When the taxpayer tenders the $7,000 payment, he will have been deemed to have paid the full amount of the initially disputed debt. Accordingly, there is no tax consequence to the taxpayer upon payment.356

The $3,000 should be treated as COD income.357 Professors Kahn and Kahn commented that Third Circuit’s “conclusion [of its example] is incorrect.”358 They reasoned that “[t]he borrower obtained $10,000 cash and returned only $7,000. The $3,000 cash he received that was not included in his income because of the debt is now free from any liability.”359 Therefore, “[r]egardless of what legitimate reasons there might be for the borrower to not be liable for part of that debt, the borrower must include $3,000 in income when that amount of the debt is cancelled.”360 Professor Seto, commenting on why the Third Circuit opinion was not given much respect by scholars, noted that “[a]ll well-trained tax lawyers know that [the Third Circuit example] is ‘wrong’ .... The effect of the explanation ... was to destroy the credibility of what might otherwise have been a plausible opinion.”361 Professor Seto, however, appears to be one of the few commentators who would characterize the Third Circuit analysis as even close to a plausible opinion.362

The contested liability doctrine was simply not appropriate to the facts of Zarin. There was no dispute that Resorts loaned Zarin $3.435 million.363 If Zarin had changed his mind

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356 Zarin, 916 F.2d at 115.
357 Kahn & Kahn, supra note 3, at 206.
358 Id.
359 Id.
360 Id.
361 Seto, supra note 213, at 1792.
362 See Kulper, supra note 345, at 642; Kahn & Kahn, supra note 3, at 205–06; Shaviro, supra note 11, at 253–54.
about gambling away the proceeds, after perhaps getting help
for his addiction, he could have cashed in his chips and used the
proceeds to extinguish his debt to the extent of the dollar value
of the chips.\footnote{364 Professor Seto pointed out:
New Jersey law prohibited the redemption of a credit gambler’s
chips for cash or their removal from the casino, requiring that
they first be applied against the gambler’s outstanding credit
balance. In effect, the only thing Zarin could have done with
his chips was to pay down his unenforceable debt. Seto, \textit{supra} note 213, at 1792.}
Alternatively, Zarin could have exchanged his chips when he was on a winning streak. Under both
of those circumstances, the amount of the debt would be clearly
equal to the chips which he was entitled to receive, $3.435 mill-
on. As to why the parties settled for $500,000, perhaps Resorts
believed that they could not recover anymore from him given his
financial position and decided to forego additional litigation ex-
 pense. The parties may have instead reached a consensus that
the odds of a court finding the debt was enforceable was unlikely,
but not impossible. As Judge Stapleton described it in his dis-
senting position, “Resorts settled for 14 cents on the dollar pre-
sumably because it viewed such a settlement as reflective of the
odds that the debt would be held to be enforceable.”\footnote{366
Professor Barton posited as another possible reason: Resort’s concern
about adverse publicity.\footnote{367 It could have been a combination of
some or all of these reasons. The fact that the matter was settled
for substantially less than the agreed terms of the original loan
does not mean that the parties disagreed as to the amount of the
original indebtedness. They did not and the debt, therefore,
should be liquid. The settlement did not change a liquid debt to
an illiquid one.}
There was also a policy reason as to why the Third Cir-
cuit’s position on the application of the contested liability doc-
trine to \textit{Zarin} made no sense. One commentator pointed out that
if this position were widely adopted, then “parties will always

\footnote{365 Professor Seto reported that Zarin “joined Gamblers Anonymous and
became Chair of the Advisory Board to the National Foundation for the Study of
Pathological Gambling. He never gambled again.” \textit{Id.} at 1761 (footnotes omitted).}
\footnote{366 \textit{Zarin}, 916 F.2d at 118 (Stapleton, J., dissenting).}
\footnote{367 \textit{See} Barton, \textit{supra} note 168, at 764.}
invoke the disputed debt doctrine to avoid taxation. Thus, taxation of [COD income from] unenforceable debts will cease. This result [would] clearly [serve to] frustrate[] ... the will of Congress.”

In its argument as to why the contested liability doctrine should pertain to Zarin, the Third Circuit also examined and cited with approval the Tenth Circuit decision in Hall, discussed above. The Third Circuit stated that:

In effect, the [Tenth Circuit in Hall] held that because the debt was unenforceable, the amount of the loss and resulting debt cognizable for tax purposes were fixed by the settlement at $148,110. Thus, the Tenth Circuit lent its endorsement to the contested liability doctrine in a factual situation strikingly similar to the one at issue.

The Third Circuit rejected the Service’s argument that “the decision in Hall was based on United States Supreme Court precedent since overruled, and therefore Hall should be disregarded. Indeed, the Hall court devoted a considerable amount of time to Bowers v. Kerbaugh-Empire ..., a case whose validity is in question.” The Third Circuit responded that, without deciding whether Kerbaugh-Empire is still valid, “Hall relied on [Kerbaugh-Empire] only for the proposition that ‘a court need not in every case be oblivious to the net effect of the entire transaction.’”

The later Tenth Circuit decision, Preslar, discussed infra, certainly marginalized Hall. There the court stated:

Whether Hall has continued viability is questionable in light of the Supreme Court’s holding in Tufts. The emphasis on a taxpayer’s lack of legal obligation to pay a gambling debt in Hall is difficult to reconcile with Tuft’s disregard of the nonrecourse nature of a loan in calculating gross income.

While there was relatively little discussion by the Third Circuit regarding theories as to when COD income should or should

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368 Kulper, supra note 345, at 642.
369 See Zarin, 916 F.2d at 115–16.
370 Id.
371 Id. at 116 n.11.
372 Id. (citing United States v. Hall, 307 F.2d 238, 242 (10th Cir. 1962)).
373 See Preslar v. Comm’r, 167 F.3d 1323, 1329 (10th Cir. 1999).
374 Id.
not arise, it relied upon and quoted N. Sobel that “the note forgiven by the bank 'was not the occasion for a freeing of assets and that there was no gain ....’”\textsuperscript{375} Its citation and discussion of Hall could also be construed as embracing the freeing of assets approach.\textsuperscript{376} As discussed below, Professor Chad J. Pomeroy was of the view that the Third Circuit implicitly utilized the freeing of assets methodology.\textsuperscript{377}

In a generally well-reasoned and cogent dissent, Third Circuit Judge Stapleton, without expressly referring to the loan proceeds theory, effectively utilized this approach (despite some language suggestive of the freeing of assets methodology) in finding Zarin had COD income in 1981.\textsuperscript{378} Judge Stapleton stated that

\begin{quote}
[d]espite the fact that Zarin received in 1980 cash or an entitlement worth $3.4 million,\textsuperscript{379} he correctly reported in that year no income from his dealings with Resorts. He did so solely because he recognized, as evidenced by his notes, an offsetting obligation to repay Resorts $3.4 million in cash.\textsuperscript{380}
\end{quote}

With the settlement in 1981, Judge Stapleton reasoned, “Resorts surrendered its claim to repayment of the remaining $2.9 million of the money Zarin had borrowed. As of that time, Zarin's assets were freed of his potential liability for that amount and he recognized gross income in that amount.”\textsuperscript{381} Judge Stapleton indicated that the alternative of finding that Zarin did not have income is “unacceptable as inconsistent with the fundamental principle of the Code that anything of commercial value received by a taxpayer is taxable unless expressly excluded from gross income.”\textsuperscript{382} The other option, i.e., to tax Zarin in 1980 (that was suggested by Judge Jacobs in his Tax Court dissenting opinion)

\textsuperscript{375} Zarin, 916 F.2d at 115 (citing N. Sobel, Inc. v. Comm'r, 40 B.T.A. 1263, 1265 (1939)) (emphasis added).
\textsuperscript{376} See Pomeroy, supra note 74, at 1694–95.
\textsuperscript{377} Id. at 1695.
\textsuperscript{378} See Zarin, 916 F.2d at 117 (Stapleton, J., dissenting).
\textsuperscript{379} This amount, also referred to in the majority opinion, \textit{id.} at 116, is apparently rounded version of the actual $3.435 million figure. Id at 117 (citations omitted).
\textsuperscript{380} Id. (citations omitted).
\textsuperscript{381} Id. (citations omitted).
\textsuperscript{382} Id. at 118 (footnote omitted) (citations omitted).
was, according to Judge Stapleton, “unacceptable as impractica-
ble.” He explained that:


Judge Stapleton concluded that in his view “where something that
would otherwise be includable in gross income is received ... there
should be no recognition of income so long as the debtor continues to
recognize an obligation to repay the debt.” He added that, “in-
come, if not earlier recognized, should be recognized when the debt-
or no longer recognizes an obligation to repay and the creditor
has released the debt or acknowledged its unenforceability.”

Judge Stapleton used a footnote to address the lack of rel-
relevance of sections 108(e)(5) and 108(d)(1). As to section
108(e)(5), he stated that “[a]mong other things, § 108(e)(5) nec-
essarily applies only to a situation in which the debtor still holds
the property acquired in the purchase money transaction.” As
to the absence of significance of section 108(d)(1) to Zarin, Judge
Stapleton indicated that the literal language of the provision
should apply, i.e., the definition provided is “[f]or purposes of
this section ....” He wrote, “[e]qually irrelevant is § 108(d)'s
definition of ‘indebtedness’ relied upon heavily by the court. Sec-
tion 108(d) expressly defines that term solely for the purposes of
§ 108 and not for the purposes of § 61(a)(12).” While moot if
one accepts the Third Circuit majority findings that Zarin did
not meet either section 108(d)(1)(A) “[indebtedness] for which
the taxpayer is liable” (a very dubious judgment) and section
108(d)(1)(B) because he did not “have a debt subject to which he

383 Id.
384 Id.
385 Id.
386 Id. (footnote omitted).
387 See id. at 118 n.3.
388 Id. He did not address whether he believed the chips were “property”
for this purpose, presumably because he thought it moot. Id.
390 Zarin, 916 F.2d at 118 n.3 (Stapleton, J., dissenting).
held property as required by section 108(d)(1)(B),” the scholars are divided as to Judge Stapleton’s reasoning as to the limited scope of section 108(d)(1). Professor Shaviro found merit in Judge Stapleton’s assessment. He noted that:

Section 61(a) is a provision of broad inclusion, listing items within the ambit of gross income, while § 108 serves to carve out specific exceptions to the broad reach of § 61(a). It is plausible that only a subset of all cancellation of indebtedness income, conceived in the broadest sense, would be made eligible for the carveout.

Professor Dodge apparently concurred, as does this writer. This, however, was disputed by Professor Seto, who stated that

[t]he history of § 108 and its predecessor sections strongly suggests that it was intended to address whatever ‘debt’ might otherwise be subject to the discharge of indebtedness doctrine. ... [Section] 61(a)(12) was apparently added only for purposes of completeness and has never previously been construed as having independent substantive effect.

Professor Seto added that “[t]o hold that § 61(a)(12) encompasses discharges of unenforceable debt but that § 108 does not would lead to very peculiar results. A discharge of unenforceable debt, for example, would be income, but would be ineligible for the statutory insolvency exception of I.R.C. § 108(a).”

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391 Id. at 113. Zarin’s failure to satisfy section 108(d)(1)(B) is self-evident, i.e., he did not possess the chips when the debt was settled. Id.
392 See Shaviro, supra note 11, at 253; Dodge, supra note 19, at 677–78; Seto, supra note 213, at 1792.
393 See Shaviro, supra note 11, at 253. Professor Musselman also agreed. See Musselman, supra note 6, at 617.
394 Shaviro, supra note 11, at 253.
395 See Dodge, supra note 19, at 677–78 (“The parameters of [COD] income are determined neither by § 108 nor the § 61 regulations, but rather by the evolving ‘common law’ of gross income.”). Professor Barton also appeared to be in agreement, when she wrote that “[a] determination of the inapplicability of section 108 to the unenforceable gambling debt should have shifted the inquiry to why the discharge occurred, and to whether a discharge for that reason amounted to a taxable accession to wealth.” Barton, supra note 168, at 755 (footnote omitted).
396 Seto, supra note 213, at 1792 n. 199.
397 Id.
As an aside, Professor Shaviro thought that one of the several failings with the Third Circuit’s reasoning was that even if Zarin’s income was determined to be excluded from being treated as COD income, he could still be taxed under the broad reach of section 61. He argued that “[w]hen a taxpayer receives something of value in a commercial setting, the government does not have the burden to show what type of income it constitutes.” That is, assuming arguendo that Zarin did not meet the requirements of section 108(d)(1)(A) or (B) and that such failure applied to whether he had income under then section 61(a)(12), he could still be found to have taxable income in 1981 from the settlement.

C. Scholarly Commentary

Professors Chirelstein and Zelenak wrote that “[o]nly a grouch would object to the outcome in Zarin.” According to Professor Schenk “[t]he vast majority of commentators think that Zarin did not have COD income.” Defending the Tax Court’s decision that he should be taxed is somewhat daunting in light of the forgoing and that he is a somewhat sympathetic figure who lost a sizeable amount of money from pursuing the adrenaline rush of gambling that was certainly encouraged by Resorts. Furthermore, given his 70% tax bracket in 1981 he would have owed about $5.2 million, despite being out of pocket $500,000 from the settlement with Resorts, had he lost his appeal.

As a start, it is useful to review some of the comments and arguments made by a few of the scholars regarding the Zarin decisions. This writer’s brief snippets certainly do not do justice to some brilliant scholarship that was engendered by Zarin.

Professor Calvin Johnson, who vehemently disagreed that the contested liability/disputed debt doctrine was applicable to Zarin, utilized the Third Circuit’s flawed hypothetical to make his

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398 See Shaviro, supra note 11, at 253.
399 See id.
400 See id.
401 CHIRELSTEIN & ZELENAK, supra note 27, at 64.
402 Schenk, supra note 12, at 169 n.100.
403 Id. at 167.
argument. He contended that “[t]here is ... a simple straightforward reason why Zarin should win: The 1981 forgiveness of his markers was a recovery of an expense for which Zarin had no prior tax benefit. Zarin has no income under the exclusionary, pro-taxpayer branch of the tax benefit rule.” Professor Johnson stated that:

[u]nder the exclusionary or pro-taxpayer branch of the tax benefit rule, a taxpayer may exclude the recovery of an expenditure from income, where the expenditure gave the taxpayer no prior tax benefit. The taxpayer may be viewed as, in effect, having a basis in the expenditure, which the taxpayer may use to shelter the recovery from tax, provided the expenditure did not previously generate a tax savings.

Professor Johnson asserted that “Zarin had a recovery of his prior losses when he failed to pay for the chips gambled away in the prior years and the recovery was an exempt recovery of an item without prior tax benefit.”

Professor Musselman would also find for Zarin (at least with respect to some, if not all, of the income), although he too had problems with the Third Circuit’s reasoning, but did not subscribe to Professor Johnson’s analysis. Under Professor Musselman’s proposed methodology for determining whether a taxpayer has COD income, discussed above,

it must simply be determined whether such discharge resulted in a clearly realized accession to the taxpayer's wealth, and in what amount ... the amount of any such accession to wealth is determined by the value of anything the taxpayer received as a result of any such discharge of indebtedness ....

Under his approach, normally in

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405 Id. at 697–98.
406 Id. at 700–01.
407 Id. at 706.
408 See Musselman, supra note 6, at 644.
409 See id. at 617–18.
410 See id. at 630–31.
411 Id. at 632–33 (footnotes omitted).
an arm’s length agreement to incur a debt in exchange for services should ... result in a legal presumption that the value of the services received by the taxpayer is equal to the amount the taxpayer agreed to pay for them, [but Zarin presented exigent circumstances including his compulsive gambling and Resorts illegally extending him credit].

These factors, Professor Musselman believed, “g[i]ve rise to a serious question of whether the taxpayer received value in a lesser amount than the debt incurred.”

Professors Kahn and Kahn believed Zarin should not have had COD income. They asserted that “[t]he cancellation of the debt in Zarin can be seen through the transactional approach as nothing more than a reduction of the cost of the gambling experience.” They reason “that the taxpayer never received anything of value whose purchase price could not be adjusted when the amount of the debt was reduced.” They shared, with many other scholars, a negative view of the Third Circuit opinion, writing that “the Third Circuit advanced two independent rationales neither of which is convincing.”

Professor Stephen A. Zorn suggested viewing Zarin “from the point of view of the casino, and use its expected return in advancing the money to the taxpayer in Zarin as a measure of the amount gambled.” He believed that:

the unenforceability of gambling debts (at least through the courts) would be a legitimate factor to consider, and a court might well reach the conclusion that, in advancing $3.4 million of in-house gambling credit to the taxpayer, the casino in fact had a reasonable expectation of receiving not more than the $500,000 that it ultimately received ....

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412 Id. at 644 (footnote omitted).
413 Id. (footnote omitted).
414 See Kahn & Kahn, supra note 3, at 203–06.
415 Id. at 206.
416 Id. at 205.
417 Id. at 203.
419 Id.
Therefore, Professor Zorn was of the view that “there would be no discharge of indebtedness income.”\textsuperscript{420} One problem with this approach is that it requires a court to determine that Resorts never expected to be repaid the $3.435 million advanced to Zarin.\textsuperscript{421} One should not simply surmise that by settling on $500,000, that was what Resorts had intended at the time the credit was advanced.

Professor Alan Gunn indicated that “Zarin’s transactions with the casino are best characterized as the purchase of the opportunity to gamble for $500,000.”\textsuperscript{422} While Professor Gunn agreed with the Tax Court that section 108(e)(5) was inapt because there was no purchase of property, he believed that there is a non-statutory purchase price adjustment exception for services that “could easily have been extended to cover a situation like Zarin’s.”\textsuperscript{423}

Professor Richard C.E. Beck thought the Third Circuit outcome was correct, but because “Zarin received neither money nor goods nor services, and because he received no consideration in exchange for his debt, he was left with nothing of value when the debt was canceled, and he should not be taxed.”\textsuperscript{424} He believed that since Resorts should never have extended Zarin credit, that “the parties should be put back into the positions they were in before

\textsuperscript{420} Id.
\textsuperscript{421} See id.
\textsuperscript{422} Alan Gunn, Another Look at the Zarin Case, 50 TAX NOTES 893, 895 (1991).
\textsuperscript{423} Id. at 895. Professor Seto is in accord. He observed that [a]t the trial court level, Zarin had not argued the nonstatutory purchase price adjustment exception, and the court therefore had no reason to address it. The nonstatutory exception, however, is not limited to “property.” Consider, for example, the following scenario. A law firm sends Taxpayer a bill for $100,000 for nondeductible services. Although the firm might win if it sued for the $100,000 and although the client does not formally dispute the bill, discussions lead the firm to reduce its charges to $75,000 in what the real world would view as a purchase price adjustment. Under the nonstatutory exception, the partial discharge does not result in income to the client, even though the services are clearly not “property.”

Seto, supra note 213, at 1785.

the transactions were entered into. ... [I.e.,] the gambling losses [should be] rescinded.” He equated Zarin to the contested liability decision N. Sobel, the case cited by the Third Circuit in Zarin, but whose application to liquidated debt (whether or not enforceable) was refuted in Preslar. Under Professor Beck’s reasoning,

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\text{[if Sobel’s stock purchase had been for cash and the effect of rescission were a return of Sobel’s cash, it would be obvious that the reimbursement was simply a tax-free return of capital. The same is true for Zarin. Zarin simply got his money back, he gained nothing, and the casino lost nothing (except its hoped-for gain).} \]

Professor Shaviro, who acknowledged that “Zarin is a case without a right answer,” would have held for the taxpayer “on the ground that there was no untaxed benefit because the settlement cost presumably equaled the expected purchase price given the ex-ante doubtfulsness of repayment.” He too was very

\[425\] Id. at 713.

\[426\] See id. The Third Circuit reasoned that “[t]here is little difference between the present case [Zarin] and Sobel” and determined that “the transaction between Zarin and Resorts can be best characterized as ... contested liability,” thereby rejecting the Tax Court’s reasoning that contested liability was barred in Zarin. Zarin v. Comm’r, 916 F.2d 110, 115–16 (3d Cir. 1990) (stating that Sobel “stands for the proposition that ‘there must be a liquidated debt’”) (citing Colonial Sav. Ass’n v. Comm’r, 85 T.C. 855, 862–63 (1985)); see also N. Sobel, Inc. v. Comm’r 40 B.T.A. 1263, 1265 (1939). The court in Preslar found that to “implicate the contested liability doctrine the original amount of debt must be unliquidated ... [not] the mere fact that the taxpayer challenges the enforceability of the debt.” Preslar v. Comm’r, 167 F.3d 1323, 1327–29 (10th Cir. 1999) (citing Comm’r v. Tufts, 461 U.S. 300, 311–13 (1983); N. Sobel, 40 B.T.A. at 1263–65; Zarin, 916 F.2d at 115–16; Shaviro, supra note 11, at 256; Giangiordano, supra note 86, at 1202 n.88).

\[427\] Cancellation of Debt, supra note 424, at 713. Zarin was still obviously out his $500,000 settlement. See Zarin, 916 F.2d at 112.

\[428\] Shaviro, supra note 11, at 250.

\[429\] Id. at 258 (footnote omitted). Professor Shaviro also expressed the view that ignoring the correct legal analysis, holding for Zarin would constitute the equitable result. He mused that:

the belief that Zarin was too unfortunate to have $3 million of taxable income makes the Tax Court’s decision intdutively dis-tasteful even if one agrees with it. Pity for Zarin’s plight is only one reason for the pro-taxpayer intuition, however. A second reason is the side of the ledger on which the issue arose: the
disparaging of the Third Circuit opinion. He stated that “[g]iven the serious problems with the Third Circuit’s reasoning, one fervently hopes that it will fail to live on as precedent for any broad proposition of tax law.”

Professor Joseph M. Dodge noted, near the beginning of his article on Zarin, that “the stimulus for this article is a recent piece by Professor Daniel Shaviro, which contains a penetrating critique of the various options handed down in Zarin.” Very helpfully, Professor Dodge agrees with the following items concerning Zarin (this writer is in accord with many, but not all, of these positions):

1. The existence of debt-cancellation income is not dependent upon a “freeing of assets” theory.
2. The parameters of such income are determined neither by § 108 nor the § 61 regulations, but rather by the evolving “common law” of gross income.
3. The loan was a valid loan for tax purposes when made even if it was legally unenforceable.
4. Commissioner v. Tufts mandates that the debt be treated, consistently with the foregoing, as being valid when cancelled (even if unenforceable).
5. The Third Circuit majority’s statement that a compromise of a cash loan does not give rise to debt-cancellation income is a serious blunder.
6. Chips are not “property” under § 108(e)(5) (the statutory purchase-price reduction rule).
7. A purchase-price reduction rule exists independently of the statute, where the purchase-money debt relates to consumption rather than an asset.
8. Bowers v. Kerbaugh-Empire Corp., which allowed debt-cancellation income to be excluded on the ground that such income was

fact that Zarin was being charged with additional gross income, not denied the deduction of a loss.

Id. at 239. Professor Shaviro also, while not “ground[ing] the decision” because of it, “conclude[d] that compulsive or addicted gamblers should not be taxed on cancellation of indebtedness income when they settle at a discount gambling debts that were at least possibly unenforceable when entered into.” Id. at 250.

430 Id. at 258.
431 Id.
432 Dodge, supra note 19, at 677 (footnote omitted).
433 As to item #8, this writer agrees if the word “is” was replaced by “should.” See id. at 678. With respect to #7, this writer agrees that there certainly are valid arguments that section 108(e)(5) does not preempt a court from applying a non-statutory purchase price reduction for services but as explained infra does not subscribe to its application to Zarin. See id. at 677–78. He is in accord with the rest of Professor Dodge’s assertions.
less than the loss on the transaction funded by the borrowed money, is no longer good law.\textsuperscript{434}

Professor Dodge believed that Zarin should not have income from the transaction, but for reasons that differ from that of the Third Circuit.\textsuperscript{435} His central premise was that Zarin ‘received’ neither property nor cash, but only (if anything) consumption, which appears in the tax base as $500,000, the amount spent on it.\textsuperscript{436} He considered it “plausible [but inaccurate] to say that the chips were purchased with ‘borrowed money’ ....”\textsuperscript{437} Professor Dodge concluded “that there can be no debt-cancellation income where consumption is purchased on credit in commerce and the debt is subsequently cancelled or settled.”\textsuperscript{438} Under Professor Dodge’s rationale, “one cannot simply assume that Zarin received $3.4 million in money or money’s worth from the gambling transactions because $3.4 million was the face amount of the liability.”\textsuperscript{439}

Professor Seto argued that the Tax Court’s conclusion that “the actual value of Zarin’s chips equaled their face value—$3,435,000 [was erroneous].”\textsuperscript{440} This was, he contended, because New Jersey law required that the chips “first be applied against the gambler’s outstanding credit balance.”\textsuperscript{441} This does not seem to undercut that the chips face value equaled the $3.435 million debt obligation. For example, if Zarin were to quit when he was ahead, e.g., with $3.6 million worth of chips, the first $3.435 million would go to the house to offset his debt and the remaining $165,000 worth of chips could be redeemed for their cash equivalent.

Another argument Professor Seto made that was consistent with one advanced by Professor Dodge and others is that “[w]hen purchase money debt is partially discharged, we must decide which price—original or adjusted—should be deemed to represent the value of the item for tax purposes.”\textsuperscript{442} That is, “[i]f ... the adjusted

\textsuperscript{434} Id. at 677–78 (footnotes omitted).
\textsuperscript{435} Id. at 682.
\textsuperscript{436} Dodge, supra note 19, at 682.
\textsuperscript{437} Id. at 679.
\textsuperscript{438} Id. at 683 (footnote omitted).
\textsuperscript{439} Id. at 679.
\textsuperscript{440} Seto, supra note 213, at 1771.
\textsuperscript{441} Id.
\textsuperscript{442} Id. at 1773.
price is the item’s deemed value, then the discharge merely brings
the price actually paid into line with the item’s deemed value.”

Professor Seto’s article also provided “ways of thinking
about what happened: a theorist’s account,” including examin-
ing the case through the lens of the Haig-Simons definition of
income. Professor Seto furnished the foregoing assessment of
what he believed the right answer was with respect to Zarin:

A strong practical argument can be made that unenforceabil-
ity should not determine whether discharged gambling debt is
taxable. A strong theoretical argument can be made that los-
ing gamblers do not receive commensurate consumption value,
even if their debts are enforceable. It may also be true that
the Code does not treat gambling as a consumption activity.
And any tax rule governing the discharge of gambling debts
must work in both market and nonmarket contexts. For all of
these reasons, I suggest that the rule of United States v. Hall
is in fact “correct”—that the discharge of gambling debts
should be treated as nontaxable per se.

Professor Zelenak would have decided in favor of the taxpayer,
although he, like several other commentators found “the opinion of
the Third Circuit majority [to be] technically indefensible ....” He
subscribed to the view expressed by Judge Tannenwald that:

In all the decided cases involving the cancellation of indebted-
ness, the taxpayer had, in a prior year when the indebtedness
was created, received a nontaxable benefit clearly measurable
in monetary terms which would remain untaxed if the subse-
quent cancellation of the indebtedness were held to be tax
free. Such is simply not the case herein.

Professor Zelenak, like some other scholars, rejected the notion that
Zarin should be viewed “as a case of gambling with borrowed

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443 Id.
444 Id. at 1793 (the topic is discussed at 1793–1807).
445 See Seto, supra note 213, at 1795–99; Henry C. Simons, Personal
Income Taxation 50 (1938); Robert Murray Haig, Readings in Economics
446 See Seto, supra note 213, at 1808.
447 See Zelenak, supra note 8, at 323.
448 Id. at 322 (footnote omitted) (citing Zarin v. Comm’r, 92 T.C. 1084, 1101
(1989) (Tannenwald, J., dissenting)).
cash ....” Thus, if one agrees with Professor Zelenak, Zarin would not be construed as a loan followed by the purchase of the right to gamble and there would be no tax benefit when Zarin received the gambling credit of $3.435 million. Therefore, under the loan proceeds methodology there would be no COD income upon settlement.

Professor Barton, who would have found Zarin taxable, rejected the notion that the face value of the chips and loan were less than $3.435 million. She pointed out that “[t]he fact that Zarin spent $2.5 million of his own funds for chips of an equivalent $2.5 million face value corroborates the $3.435 million face value of the chips and debt.” She disagreed with the notion advanced by some other scholars that “the figure at the date of settlement consumption is [on policy grounds] the appropriate measure of the debt ....” Professor Barton considered that “the otherwise unsupported assertion that the size of Zarin’s debt equaled its $0.5 million settlement value appears to be a result-oriented pronouncement advanced on the basis of Zarin’s acknowledged compulsive condition.”

Professor Barton was sympathetic to Zarin’s plight despite her conclusion that he should have had COD income. She recognized that he was “[d]riven to gamble compulsively by a psychological aberration, [he] suffered dearly from loss of personal fortune. The toll from his compulsive gambling would have been grossly aggravated had the tax levy growing out of that very aberration been sustained.” Nevertheless, she believed it was not up to the courts, but Congress to address these types of circumstances.

Professors McMahon and Simmons also believed Zarin should have been taxed. They wrote that “Zarin was erroneously
decided and is unlikely to be generally followed.” They reasoned that “[u]nder accepted principles that gross income includes the objective, rather than subjective, value of items received in a market transaction, the effect of the Third Circuit’s opinion was to allow Zarin to receive $2.9 million tax-free, even though none of the exceptions to section 61(a)(12) or section 108 applied.”

Professor Schenk also thought that Zarin should have had COD income. She pointed out that, as Judge Stapleton noted in his dissent, “regardless of whether the loan was enforceable, Zarin received something of value when he undertook the obligation which was not taxable.” She commented that “[i]f Zarin had borrowed the $3.5 million from his local bank before arriving at the casino and then lost it all gambling, he clearly would have had COD income if the bank discharged the debt.” The funds were, as described by Professor Deborah A. Geier, “received free of tax on the assumption that it would be repaid with after-tax dollars. When that assumption proves unwarranted by $2,935,000, the debtor’s accession to wealth is apparent.”

Professor Schenk also posited that

[a]nother way to reach the same result [i.e., that Zarin should be taxed] without delving into debt discharge theory is to tax Zarin because he enjoyed consumption that he did not pay for and was not a gift from the transferor. What Zarin purchased with loan proceeds was entertainment (the right to gamble).

Assuming an objective measure of enjoyment, i.e., spending, that ignores the psychological state of a compulsive gambler, this too

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461 Id.
462 Id.
463 See Schenk, supra note 12, at 169.
464 Id. (citing Zarin v. Comm’r, 916 F.2d 110, 118 (3d Cir. 1990) (Stapleton, J., dissenting)). Professor Joel S. Newman was also in accord that Zarin should have been taxed. Joel S. Newman, Five Will Get You Ten; You Haven’t Heard the Last About ‘Zarin’, 50 TAX NOTES 667 n.7d (1991).
465 Schenk, supra note 12, at 169.
466 Deborah A. Geier, Tufts and the Evolution of Debt-Discharge Theory, 1 FLA. TAX REV. 115, 187 n.217. Her statement, however, was written under the assumption that the money was borrowed from a third-party creditor and not Resorts. See id. at 187.
467 Schenk, supra note 12, at 169 n.99.
appear to be a reasonable means of further supporting the correct conclusion.468

While this writer does not concur with some of the Zarín-related commentary, this does not detract from his admiration for some very superb scholarship provoked by the case. Only a relatively small part was touched upon by this Article. Despite the conclusion reached here that Zarín should have had COD income, the well-reasoned counter-arguments certainly elicit at least some doubt.

D. Preslar v. Commissioner

The post-Zarín Tenth Circuit decision Preslar v. Commissioner merits discussion. There the court found the contested liability doctrine inapplicable in a case with a liquidated debt obligation.469 In Preslar, the husband and wife taxpayers purchased a 2,500 acre ranch in New Mexico.470 The consideration was $1 million, which was financed with a promissory note by Moncor Bank.471 The taxpayers’ plan was to subdivide the ranch into cabin and vacation homes for hunters and others seeking outdoor recreation.472 Moncor Bank allowed the taxpayers to repay the indebtedness “by assigning the installment sales contracts of purchasers of cabin lots to [it] at a discount.”473 Subsequently, “Moncor Bank was declared insolvent and the Federal Deposit Insurance Corporation (FDIC) was appointed as receiver.”474 The FDIC “refused to accept further assignments of sale contracts as repayment and ordered the Preslars to suspend sales of cabin lots.”475 While the taxpayers stopped its sales, it also ceased making further payments to the FDIC.476 They also “filed an action against the FDIC for breach of contract ... seeking

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468 Professor Dodge asserted that “the measure of consumption under the income tax law is what was spent, not the value of what was acquired ... psychic goods are not the measure of the tax base ....” Dodge, supra note 19, at 681 (footnotes omitted).

469 Preslar v. Comm’r, 167 F.3d 1323, 1325 (10th Cir. 1999).

470 Id.

471 Id.

472 Id.

473 Id.

474 Id.

475 Id. at 1325–26.

476 Id. at 1326.
an order requiring the FDIC to accept assignment of sales contracts as loan repayment." 477 The litigation was eventually settled for payment of $350,000 (which the taxpayers borrowed from another bank). 478 The result, after taking prior payments into consideration, was that slightly less than $450,000 was no longer owed by the taxpayers to FDIC from the initial loan. 479 After an audit, the Service assessed a deficiency on grounds that the Preslars had discharge of indebtedness income of the approximate $450,000, which the FDIC agreed not to collect. 480

The taxpayers argued in Tax Court that “their settlement with the FDIC [was] a purchase price adjustment under § 108(e)(5) and/or common law.” 481 The Service asserted “that the Preslars could not invoke § 108(e)(5) because that provision applies only to situations where the seller of property agrees to reduce the amount of the purchaser’s debt flowing from the property sale.” 482 Furthermore, “[t]he party responsible for reducing the Preslars’ debt was not the seller but was the FDIC (as receiver for Moncor Bank) thereby rendering § 108(e)(5) inapplicable.”

The Tax Court ignored the question of the applicability of section 108(e)(5) and “sua sponte invoked the contested liability doctrine and held the Preslars’ unusual payment arrangement with Moncor Bank caused their liability for the full $1 million loan to be brought into question.” 484 The Tax Court “determined the true amount of the Preslars’ indebtedness was not firmly established until they settled with the FDIC; thus, no discharge-of-indebtedness income could have accrued to the Preslars as a result of the settlement.” 485

The Tenth Circuit reversed the Tax Court and rejected the appropriateness of applying the contested liability doctrine to the case at bar. 486 The Tenth Circuit examined both N. Sobel and the Third Circuit decision in Zarin, where both courts found

\[477\] Id.
\[478\] Id.
\[479\] Id.
\[480\] Id.
\[481\] Id.
\[482\] Id.
\[483\] Id.
\[484\] Id.
\[485\] Id.
\[486\] Id. at 1328.
the doctrine germane. The Tenth Circuit in *Preslar* was very critical of the Third Circuit’s analysis in *Zarin*, commenting:

> The problem with the Third Circuit’s holding [in *Zarin*] is it treats liquidated and unliquidated debts alike. The whole theory behind requiring that the amount of a debt be disputed before the contested liability exception can be triggered is that only in the context of disputed debts is the Internal Revenue Service (IRS) unaware of the exact consideration initially exchanged in a transaction. ... The mere fact that a taxpayer challenges the enforceability of a debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute. To implicate the contested liability doctrine, the original amount of the debt must be unliquidated. A total denial of liability is not a dispute touching upon the amount of the underlying debt. ... [Quoting a commentator] “Enforceability of the debt ... should not affect the tax treatment of the transaction. If the parties initially treated the transaction as a loan when the loan proceeds were received, thereby not declaring the receipt as income, then the transaction should be treated consistently when the loan is discharged and income should be declared in the amount of the discharge.”

Judge Ebel’s *Preslar* dissent pointed out that in *N. Sobel*,

> When the note became due the corporation refused to pay, disputing not the amount of the note but rather the validity of the note itself “on the ground that the bank made the loan in violation of law and failed to carry out promises to guarantee the [corporation] against loss.”

He further observed that “[t]he Board of Tax Appeals found no discharge of indebtedness income, even though the corporation did not dispute the amount of the debt and even though the original amount was liquidated (at $21,700).” The dissent concluded its argument that *N. Sobel* was not supportive of the majority’s position with the following:

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487 *Id.*
488 *Id.* at 1328–29. The last two sentences quoted by the Third Circuit is from Giangiordano, *supra* note 86, at 1202 n.88.
489 *Preslar*, 167 F.3d at 1333–34 (Ebel, J., dissenting).
490 *Id.* at 1334 (citation omitted).
[T]he majority’s view that the contested liability doctrine applies only when the original amount of a debt is disputed and unliquidated is mistakenly narrow. This view ignores the fact that the original amount of a debt is necessarily disputed and may be unliquidated under a good faith dispute over liability “that can be traced to the circumstances in existence at the time of the debt’s creation.”

The dissent’s position regarding *N. Sobel* was, at least, somewhat doubtful. The Tenth Circuit majority indicated *N. Sobel* applied the contested liability doctrine in a case where both the liability and amount were in question. The court cited the following language from the Board of Tax Appeals decision: “There is question whether the taxpayer bought property in 1929 and question as to its liability and the amount thereof.”

Professor Musselman was among the scholars that were critical of the utilization of the contested liability doctrine to avoid COD income. He wrote that “Preslar provides a good example of the confusion produced by the contested liability doctrine, and why that doctrine, along with the freeing of assets theory, should be fully and finally discarded.”

The contested liability doctrine is a necessary corollary to the freeing of assets theory, to allow for a determination of the actual amount of the taxpayer’s liability in appropriate cases, so that the amount of discharge (and thus the amount of income from such discharge) can be determined. It is only because of the unnecessary rigidity of the freeing of assets theory that the contested liability doctrine has come into existence.

*Preslar* was instructive that *Tufts* negates lack of enforceability as opening the door to the contested liability doctrine. The Tenth Circuit stated that the conclusion it reached that “[t]he mere fact that a taxpayer challenges the enforceability of

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491 *Id.* (citations omitted).
492 *Id.* at 1328.
493 *Id.* at 1328 (citing *N. Sobel, Inc. v. Comm'r*, 40 B.T.A. 1263, 1265 (1939)).
494 See *Musselman, supra* note 6, at 651.
495 *Id.*
496 *Id.* at 646–47 (footnotes omitted).
497 *Preslar*, 167 F.3d at 1329.
a debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute ... is underscored by the Supreme Court’s holding in Tufts ...”\textsuperscript{498} The Tenth Circuit explained that in Tufts:

The Court reasoned that because the indebtedness is treated as a true debt when it is incurred, it must be treated as a true debt when it is discharged, with all the attendant tax consequences. It seems evident from this ruling that if the distinction between the recourse and nonrecourse nature of a loan has no bearing on calculation of gross income, the enforceability of a debt should be of equally minimal importance.\textsuperscript{499}

The Preslar dissent challenged the reliance on Tufts.\textsuperscript{500} Judge Ebel argued that “[n]onrecourse loans and unenforceable debts are not functional equivalent. Nonrecourse loans are enforceable, unenforceable debts are not. A party may sue to collect on a nonrecourse loan, but cannot sue to collect on an unenforceable debt.”\textsuperscript{501} The dissent observed that

[w]hile a taxpayer has no personal liability upon default of a nonrecourse loan, the taxpayer nonetheless is always liable for the loan. That liability merely is capped by the value of the underlying security interest .... Given an unenforceable debt, the taxpayer has no liability. This distinction can make all the difference for tax purposes.\textsuperscript{502}

Lee Sheppard, writing prior to Preslar, had a contrary opinion to that of the dissent as to the effect of Tufts,\textsuperscript{503} stating that “[i]f the difference between recourse and nonrecourse does not matter for tax purposes, neither should legal enforceability.”\textsuperscript{504} Her views were shared by other commentators.\textsuperscript{505}

\textsuperscript{498} Id. at 1328–29.
\textsuperscript{499} Id. at 1329.
\textsuperscript{500} Id. at 1336 (Ebel, J., dissenting).
\textsuperscript{501} Id.
\textsuperscript{502} Id. at 1336–37.
\textsuperscript{503} Lee A. Sheppard, A Gambling Exception to Cancellation of Indebtedness Income?, 49 TAX NOTES 1516, 1517 (1990).
\textsuperscript{504} Id.
\textsuperscript{505} See, e.g., Pomeroy, supra note 74, at 1690–91.
Professor Chad J. Pomeroy\textsuperscript{506} made a forceful argument that the Tenth Circuit legal analysis of \textit{Tufts} applicability was correct.\textsuperscript{507} He asserted that the Tenth Circuit was justified in holding that if the debt was “liquidated (enforceable or not), the Preslars would have to include any debt-discharge amount in gross income.”\textsuperscript{508} He viewed \textit{Tufts} as a game-changer in the resolution of whether a taxpayer has COD income.\textsuperscript{509} His contention was that the Supreme Court in \textit{Tufts} abandoned the freeing of assets approach and adopted symmetry.\textsuperscript{510} As discussed above, the Tax Court in \textit{Zarin} cited \textit{Tufts} and its concern with symmetry as part of its reasoning in determining that lack of enforceability should not prevent COD income from occurring.\textsuperscript{511} Professor Pomeroy wrote that, in \textit{Tufts},

\begin{quote}
[t]he Supreme Court ... ignor[ed] whether the discharge freed the taxpayer’s assets from obligations (or even the question of whether the taxpayer had economic incentive to honor the obligation) and instead focus[ed] on whether an untaxed discharge transaction would mean that “the mortgagor effectively will have received untaxed income at the time the loan was extended.”\textsuperscript{512}
\end{quote}

He asserted that \textit{Tufts} “was the birth of symmetry because the Court cared only about the debt money that was received on the front end of the transaction; that is, the amount that needs to be taxed on the back end of the transaction (if, of course, it is discharged).”\textsuperscript{513} Symmetry is effectively another term for the loan proceeds methodology. Professor Pomeroy stated that although

\begin{itemize}
\item\textsuperscript{506} While currently a full professor at St. Mary’s University School of Law he was a law student, albeit \textit{summa cum laude}, when his \textit{Preslar} comment was published. Chad J. Pomeroy, ST. MARY’S SCH. OF L., https://law.stmarytx.edu/academics/faculty/chad-pomeroy/ [https://perma.cc/MLA2-W732].
\item\textsuperscript{507} See, e.g., Pomeroy, \textit{supra} note 74, at 1690–91.
\item\textsuperscript{508} See id. at 1699. However, it is important to note that Professor Pomeroy believed that the Preslars’ debt was not liquidated. \textit{Id.}
\item\textsuperscript{509} See id. at 1689.
\item\textsuperscript{510} See id. at 1689; see also Schenk, \textit{supra} note 12, at 148 (referring to \textit{United States v. Centennial Bank}, the case where Professor Schenk observed “that the Court essentially cites both the loan proceeds and the freeing-of-assets theories.”). \textit{But see} United States v. Centennial Bank, 499 U.S. 573, 583 (1991) (decided after \textit{Tufts}).
\item\textsuperscript{511} See Pomeroy, \textit{supra} note 74, at 1689.
\item\textsuperscript{512} \textit{Id.} (footnotes omitted) (citing Comm’r v. Tufts, 461 U.S. 300, 310 (1983)).
\item\textsuperscript{513} \textit{Id.}
“the factual context of Tufts may have differed from the normal debt-discharge income scenario, the Court’s reasoning was broad enough to encompass all debt-discharge income.”514 Furthermore, “[w]hen one gets rid of debt, the Court simply asks whether or not the taxpayer is receiving an unwarranted accession to wealth because the IRS did not tax the amount in the beginning since it thought at the time that the taxpayer was obligated to repay the debt.”515 He noted that if one applies this methodology, the Service should “not care if the debt is enforceable because that does not affect the amount initially received and excluded.”516

Prior to the decision in Preslar, Professor Barton also emphasized the importance of Tufts, as to how Zarin should have been analyzed by the Third Circuit.517 She stated that:

If Zarin in fact derived an unpaid-for benefit in settling the $3.5 million loan for a payment of $0.5 million, the Tufts doctrine requires that he report income equal to the value of the benefit, whether or not the loan was enforceable or incurred for the purpose of gambling. It was this issue of benefit, not enforceability, that deserved the Third Circuit’s attention in Zarin.518

One other item worth mentioning in Preslar, with relevance to Zarin, was the discussion of the taxpayers’ argument that:

[T]he common law purchase price reduction doctrine may be invoked in cases where ... § 108(e)(5) is inapplicable. The Commissioner responds that § 108(e)(5) has displaced the common law on this issue and, in any event, a debt reduction by a third-party lender was not considered a purchase price adjustment under common law.519

The Tenth Circuit suggested that section 108(e)(5) may be interpreted as preempting the common law with respect to purchase money debt disputes, observing that “[i]f, as the Preslars argue, the common law rule remains viable and permits taxpayers involved in third-party transactions to treat their debt reductions as purchase price adjustments rather than additions to their gross

514 Id. at 1690 (footnote omitted).
515 Id.
516 Id. at 1692.
517 See Barton, supra note 168, at 757.
518 Id.
519 Preslar v. Comm’r, 167 F.3d 1323, 1332 (10th Cir. 1999).
income, § 108(e)(5) would be rendered meaningless.”520 However, many scholars believe there remains a common law purchase price exclusion outside of section 108(e)(5). Professors McMahon and Simmons indicated that the Tenth Circuit comment on preemption was “erroneous.”521 Professor Dodge noted that “[a] purchase-price reduction rule exists independently of the statute, where the purchase-money debt relates to consumption rather than an asset.”522 Professor Gunn expressed sentiments similar to that of Professor Dodge.523

E. Analysis

While there is a temptation to simply state, as Professor Shaviro did that “Zarin is a case without a right answer,”524 this Article proffers a resolution, but with the recognition that there are reasonable contrary positions.525 Furthermore, as discussed in the final hypothetical below, this writer would not extend Zarin to other service providers who were not also functioning as de facto lenders.526

This writer is of the opinion that the Tax Court and Judge Stapleton were correct in concluding that Zarin should have had COD income and that the loan proceeds approach is the appropriate methodology for making this determination.527 While Professor Pomeroy may or may not be right that the Supreme Court in Tufts abandoned the freeing of assets approach,528 and Professor Schenk was unconvinced,529 the utilization of the loan proceeds theory was certainly consistent with Tufts’s requirement

520 Id.
521 McMahon & Simmons, supra note 3, at 436.
522 Dodge, supra note 19, at 678.
523 See Gunn, supra note 422, at 895.
524 Shaviro, supra note 11, at 250.
525 See discussion infra Section II.E.
526 See id.
527 See id.; see also Zarin v. Comm’r, 916 F.2d 110, 118 n.3 (3d Cir. 1990) (Stapleton, J., dissenting).
528 See Pomeroy, supra note 74, at 1689.
529 See Schenk, supra note 12, at 148. But see id. at 151 (stating that “[l]egislative history indicates that when Congress revamped the insolvency rules as part of the Bankruptcy Act of 1980, it abandoned the freeing-of-assets theory in favor of the loan proceeds approach”).
This methodology rests on the proposition, articulated by Professors Bittker and Thompson, that “[d]ebtors who ultimately pay back less than they received enjoy a financial benefit whether the funds are invested successfully, lost in a business venture, spent for food and clothing, or given to a charity.” One should add “lost in gambling” to that list. Moreover, as discussed infra, none of the possible exceptions should change the result that Zarin should have had taxable income from the settlement.

Contrary to Judge Tannenwald’s dissenting Tax Court opinion in *Zarin*, and the view of some scholars, including Professor Zelenak, the debt obligation and the amount received was measurable, $3.435 million, at the time of the loans’ creation. Prior to placing his first bet, Zarin could have, if he so desired, used the gambling credit he received to extinguish his debt to Resorts, dollar for dollar. Similar treatment would have occurred if he settled when he was ahead or even behind, but not wiped out. If he had, for example, decided to quit when he was down, for example $435,000, he could have extinguished $3 million of debt with his remaining credit.

Zarin was not subject to tax when he received the chips because both parties had an understanding it would be repaid. This tax benefit he received at the time of the loans results in COD income, unless an exception applied, and none should. As described by Professors Bittker and Thompson, the “borrowed funds are excluded from gross income when received because of the assumption that they will be repaid in full and that a tax adjustment is required when this assumption proves erroneous.” This conclusion should not be undermined simply because Zarin obtained for his indebtedness gambling credit instead of cash. Even though he was out $500,000, he had a $2.935 million accession to wealth.

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530 See Geier, supra note 466, at 145.
531 Bittker & Thompson, supra note 49, at 1165.
532 See discussion infra Section II.E.
534 See Zelenak, supra note 8, at 323.
535 See, e.g., Zorn, supra note 418, at 33 & n.182; see also Zarin, 92 T.C. at 1088.
536 See Zarin, 92 T.C. at 1087–88.
537 See supra notes 98–105 and accompanying text.
538 Bittker & Thompson, supra note 49, at 1165 (footnote omitted).
under the tax laws. The fact that someone unfamiliar with federal taxation would likely find this result odd should not cause the law to be ignored.

As a hypothetical, assume a later day Zarin in 2020, were to borrow $3.435 million from a bank he intended to fund his gambling, and he placed real estate as collateral for the loan. Further suppose the following events occurred. The value of the real estate diminished substantially to $500,000. Zarin put the money he received from the bank under his mattress. His bedroom caught fire, destroying the cash before he set foot in the casino. He lacks insurance for his loss. He settled with the bank for the real estate now worth $500,000. Because of section 165(h)(5)’s limitation on casualty losses from 2018 to 2025, he does not obtain a tax deduction for his loss. While perhaps our hypothetical Zarin is as sympathetic as the real one, it should be fairly clear that he has COD income of $2.935 million.

There is an argument that the foregoing analysis misapplies the correct interpretation of the loan proceeds methodology. The reasoning essentially is that Zarin did not actually obtain $3.435 million in U.S. dollars from Resorts, and since “the debtor did not originally receive cash or other loan proceeds in exchange for incurring the debt, its cancellation should not be taxable.” That is, according to Professor Zelenak, “Zarin should be understood as a case of gambling with borrowed cash ....” It should be seen instead “as nothing more than a reduction of the cost of the gambling experience.” While this analysis is not entirely unreasonable, this way of thinking arguably opens up a Pandora’s box as to where the line is drawn. For example, what if instead, Resorts owned

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539 Zarin, 92 T.C. at 1085; supra note 409 and accompanying text.
540 See I.R.C. § 165(h)(5).
541 The fact he did not “consume” the loan proceeds should not change this result; nor should the fact, like gambling losses, he received no tax benefit for his loss.
542 Beck, supra note 99, at 166.
543 Zelenak, supra note 8, at 324. Zelenak goes on to explain that he believes Zarin would be better characterized as “merely a case of gambling without an escrow,” meaning no COD income arises. Id.
544 Kahn & Kahn, supra note 3, at 206.
545 See discussion infra Section II.E. As will be discussed at the end of this section, this writer’s distinction of Zarin from some other service providers
a bank that lent him the money to buy the chips utilized in the casino? Assuming one would agree he would have COD income in that scenario, should the answer in Zarin be different “on the happenstance that the creditor wore two hats: lender as well as vendor of the services purchased with the credit”?

If one, erroneously in the opinion of this writer, were to utilize the historic whole transaction approach, encompassing the Kerbaugh-Empire methodology, instead of the loan proceeds approach, then Zarin’s gambling losses would have precluded his being taxed because these losses would nullify an increase in net worth. This methodology is incorrect and should not be followed. Professor Dodge was of the view that, “Bowers v. Kerbaugh-Empire Corp., which allowed debt-cancellation income to be excluded on the ground that such income was less than the loss on the transaction funded by the borrowed money, is no longer good law.” Regardless of whether Professor Dodge was correct, it should “no longer [be considered] good law.” The transactional approach espoused by Professors Kahn and Kahn would similarly, but for different reasons, find no COD income; it would be treated “as nothing more than a reduction of the cost of the gambling experience.”

What about the application of the freeing of assets methodology to Zarin? To employ this approach would be mistaken, for reasons articulated by Professors Bittker and Thompson: “Such reasoning misses the point. Income results from the discharge of indebtedness because the taxpayer received (and excluded from income) funds that he is no longer required to pay back, not because assets are freed of offsetting liabilities on the balance sheet.” Commentators disagree as to the result if it had been applied to the Zarin fact-pattern. One view is that COD income would occur, because “any cancellation leads to an

who reduce or eliminate fees to customers perhaps opens up another Pandora’s box on where the line is drawn.

546 Geier, supra note 466, at 188 n.217.
547 See discussion supra Part I.
548 Dodge, supra note 19, at 678 (footnotes omitted).
549 Id.
550 Kahn & Kahn, supra note 3, at 206.
551 Bittker & Thompson, supra note 49, at 1165.
552 Compare Newman, supra note 464, at 667 n.7a, with Pomeroy, supra note 74, at 1693–94.
increase in net worth, whether the loan proceeds were used for consumption [as in Zarin] or investment.”

Professor Pomeroy, in contrast, argued the freeing of assets theory was in fact implicitly utilized by the Third Circuit in Zarin in determining the absence of COD income. He asserted that “[t]he court [in effect implicitly utilized the freeing of assets methodology] allowed the after-the-fact debt valuation because it focused on the concept of asset worth—it wanted to know how much, in Zarin’s current assets, the debt really represented at the time of purchase.” He contends that the “Third Circuit [in Zarin] searched for an answer to that question: how much was the original debt really worth? Since acknowledging that the more one has lost the more one has consumed seems odd and counterintuitive; the court refused to stop at the standard cost-based approach.” It essentially “allowed the parties to assign a value after they had concluded that the debt was legally unenforceable.” He believed that the Third Circuit “implicitly adopted a freed assets justification but did not want to explicitly say so, in light of the fact that Tufts had probably overruled that justification.”

The right conclusion that the Third Circuit should have reached was that Zarin had COD income not altered by any of the following: 1) the fact the debt was found to be unenforceable by the Tax Court; 2) the contested liability doctrine; 3) section 108(d)(1); 4) section 108(e)(5); or 5) a common law version of the purchase-money debt reduction for services. The fact that the Tax Court found the debt to be legally unenforceable (under circumstances

553 Newman, supra note 464, at 667 n.7a.
554 See Pomeroy, supra note 74, at 1693–94.
555 Id.
556 Id. at 1694.
557 Id. at 1695 (footnote omitted). Professor Pomeroy noted that the freed assets approach is more sensitive to what the initial consumption was really worth (i.e., a person would not encumber his assets unless he had some set value in mind), the court is more willing to allow parties to go back and re-decide how much things were worth if the transaction seems odd to the court. Also, the fact that Zarin only cited freed assets cases suggests that this is indeed the rationale the court was implicitly adopting.
558 Id. at 1695 n.109.
559 See discussion supra Sections II.A, II.B.
where the Service bore the burden of proof) should not have prevented COD income from occurring upon the debt’s settlement.\textsuperscript{560} The Tax Court correctly determined that “[t]he enforceability of petitioner’s debts under New Jersey law did not affect either the timing or amount and thus is not determinative for federal income tax purposes.”\textsuperscript{561}

Instead of focusing on whether the debt was enforceable, as the Third Circuit did, it should have concentrated upon what the parties intended at the time the debtor-creditor relationship commenced. The parties clearly desired to establish loans by Resorts to Zarin of $3.435 million to engage in gambling at its casino.\textsuperscript{562} Even many commentators who believed the outcome of the Third Circuit decision was correct, agreed that the Third Circuit’s concentration on the loans’ unenforceability was an improper red herring.\textsuperscript{563} Professor Dodge, citing \textit{James v. United States}, concluded that “[t]he [Resorts’] loan was a valid loan for tax purposes when made even if it was then legally unenforceable.”\textsuperscript{564} Professor Shaviro wrote that:

\begin{quote}
[l]egal enforceability should not be deemed a prerequisite to includability in gross income. It shifts the focus from economic substance, or whether the parties expect repayment, to a legal technicality that provides only one possible ground for the expectation. An expectation of repayment can also arise from personal trust founded on a mutual sense of moral obligation, or from the debtor’s self-interest if she has a business reputation to protect or there is an ongoing, mutually profitable course of dealing between the parties.\textsuperscript{565}
\end{quote}

As noted, the Third Circuit’s focus on enforceability was properly criticized by the Tenth Circuit in \textit{Preslar}, where the court stated that the

\begin{itemize}
  \item \textsuperscript{560} Pomeroy, \textit{supra} note 74, at 1694.
  \item \textsuperscript{561} Zarin v. Comm’r, 92 T.C. 1084, 1094 (1989).
  \item \textsuperscript{562} \textit{See id.} at 1105.
  \item \textsuperscript{563} \textit{See, e.g.}, Dodge, \textit{supra} note 19.
  \item \textsuperscript{564} Dodge, \textit{supra} note 19, at 678. Professor Dodge wrote that \textit{James} “is squarely on point for this proposition. There, the Court stated the test in terms of a ‘consensual recognition ... of an obligation to repay.’” \textit{Id.} at 678 n.4 (citing James v. United States, 366 U.S. 213, 219 (1961)).
  \item \textsuperscript{565} \textit{See} Shaviro, \textit{supra} note 11, at 254 n.122.
\end{itemize}
[enforceability of the debt ... should not affect the tax treatment of the transaction. If the parties initially treated the transaction as a loan when the loan proceeds were received, thereby not declaring the receipt as income, then the transaction should be treated consistently when the loan is discharged and income should be declared in the amount of the discharge.\textsuperscript{566}

As was recognized in \textit{Preslar}, this conclusion is clearly supported by the Court’s decision in \textit{Tufts}.\textsuperscript{567}

The Third Circuit in \textit{Zarin} applied the contested liability doctrine because it stated that “when a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute.”\textsuperscript{568} This was simply wrong as \textit{Preslar} indicated.\textsuperscript{569} There, the Tenth Circuit stated, “[t]o implicate the contested liability doctrine, the original amount of the debt must be unliquidated. A total denial of liability is not a dispute touching upon the amount of the underlying debt.”\textsuperscript{570} The debt in \textit{Zarin} was liquidated.\textsuperscript{571} There was no disagreement that the amount of the loans was originally set at $3.435 million.\textsuperscript{572} The Tax Court’s assessment of the invalidity of the contested liability doctrine to \textit{Zarin} was, in contrast to the Third Circuit, spot on. The Tax Court opinion stated:

There is no dispute about the amount petitioner received. The parties dispute only its legal enforceability, i.e., whether petitioner could be legally compelled to pay Resorts the fixed amount he had borrowed. A genuine dispute does not exist merely because petitioner required Resorts to sue him before making payment of any amount on the debt.\textsuperscript{573}

The Third Circuit’s rationale for applying the contested liability doctrine would expand it considerably beyond its purpose to cover situations wherein “the debtor disputes liability for the

\textsuperscript{566} \textit{Preslar v. Comm’r}, 167 F.3d 1323, 1329 (10th Cir. 1999) (quoting Giangiordano, \textit{supra} note 86, at 1202 n.88).
\textsuperscript{568} \textit{Zarin v. Comm’r}, 916 F.2d 110, 116 (3d Cir. 1990).
\textsuperscript{569} \textit{Preslar}, 167 F.3d at 1328 (footnote omitted).
\textsuperscript{570} \textit{Id.}
\textsuperscript{572} \textit{Id.} at 1088.
\textsuperscript{573} \textit{Id.} at 1095–96.
amount claimed by the alleged creditor, because such a debt is neither ‘absolute and not contingent’ nor for ‘a fixed amount.’”\(^\text{574}\) As noted by one commentator, if the Third Circuit’s reasoning to treat all unenforceable debts as subject to the contested liability doctrine, then “income from the discharge of indebtedness will never result when the underlying debt is unenforceable.”\(^\text{575}\) Limiting the contested liability doctrine to liquidated debt obligations is sound tax policy. It’s a non-statutory exception to COD income where Congress has created specific exclusions.\(^\text{576}\) Finally, the consequence of the Third Circuit’s position, which is that there is no COD income on the forgiveness of unenforceable debts, is that the proceeds that are received initially without any offsetting legal obligation to pay back should result in income in the initial year under section 61.\(^\text{577}\)

Section 108(d)(1) also does not change the result that Zarin should have had taxable income. The Third Circuit was right about section 108(d)(1) not applying, but for the wrong reason. As discussed above, section 108(d)(1) defines “indebtedness of the taxpayer” to mean “for purposes of this section ... (A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property.”\(^\text{578}\) The Third Circuit found that neither (A) nor (B) was satisfied.\(^\text{579}\) There should be little controversy that “Zarin did not hold property” when the debt was discharged because even if it were incorrectly treated to be property for purposes of this section,\(^\text{580}\) the chips were gone by the time the dispute was settled.\(^\text{581}\) The Third Circuit’s finding that “[b]ecause the debt Zarin owed to Resorts was unenforceable as a matter of New Jersey state law, it is clearly not a debt ‘for which the taxpayer is liable,’”\(^\text{582}\) was, however, in error. Lack of enforceability does not abrogate a taxpayer’s liability. As discussed, this point should be academic. This is because, as Judge Stapleton stated in a

\(^{574}\) Bittker & Thompson, supra note 49, at 1169 (footnote omitted).

\(^{575}\) Giangiordano, supra note 86, at 1200.

\(^{576}\) I.R.C. § 108(a)(1).

\(^{577}\) See Zarin, 92 T.C. at 1088.

\(^{578}\) I.R.C. § 108(d)(1) (emphasis added).


\(^{580}\) The Third Circuit correctly found it not to be “property” for this purpose.

\(^{581}\) See id. at 114.

\(^{582}\) Id. at 113.
footnote, “[s]ection 108(d) expressly defines that term solely for the purposes of § 108 and not for the purposes of § 61(a)(12).”\textsuperscript{583} As discussed above, some, but not all the commentators found, as this writer does, this to be a compelling argument.\textsuperscript{584}

Both the Tax Court and the Third Circuit determined section 108(e)(5) to be inapposite to \textit{Zarin}, albeit for different reasons.\textsuperscript{585} The statutory provision should certainly have been inapplicable, because both the gambling chips were not as the Tax Court indicated the “normal commercial property”\textsuperscript{586} intended to be covered by the provision and also that the section cannot operate in circumstances like \textit{Zarin} where the taxpayer does not own the property at time of the settlement.\textsuperscript{587} One requirement for satisfying the “purchase-money debt reduction for solvent debtors,” i.e., section 108(e)(5), which treats such transactions as price reductions rather than COD income, is that “the debt of a purchaser of property to the seller of such property ... arose out of the purchase of such property ...”\textsuperscript{588} The Tax Court determined that \textit{Zarin} incurred the indebtedness for “[t]he ‘opportunity to gamble,’” and that he did not buy “property” as that term is used in section 108(e)(5).\textsuperscript{589} Professor Seto pointed out that a major flaw in Judge Ruwe’s Tax Court dissent was that he “treated the ‘purchase’ of the chips as an event having independent tax significance.”\textsuperscript{590} As was recognized by both the Tax Court and the Third Circuit, “the chips [were] nothing more than ‘the opportunity to gamble ...[;]’ [they] are merely an accounting mechanism to evidence debt.”\textsuperscript{591} In this regard, Professor Shaviro wrote:

> Within the casino, the chips were a form of cash. They evidenced money that had been paid in or credit that had been granted, and they represented specific dollar values that could not fluctuate. The price of a chip, like the price of a five dollar bill and unlike the price of a car, was not negotiable. Thus, the dispute

\textsuperscript{583} \textit{Id.} at 118 n.3 (Stapleton, J., dissenting).
\textsuperscript{584} \textit{Supra} Section II.B.
\textsuperscript{585} \textit{Supra} Section II.C.
\textsuperscript{587} \textit{Id.} at 1099–100.
\textsuperscript{588} I.R.C. § 108(e)(5).
\textsuperscript{589} \textit{Zarin}, 92 T.C. at 1099.
\textsuperscript{590} \textit{See} Seto, \textit{supra} note 213, at 1789.
\textsuperscript{591} \textit{Zarin v. Comm’r}, 916 F.2d 110, 113 (3d Cir. 1990) (citing \textit{Zarin}, 92 T.C. at 1099).
between Zarin and Resorts could not possibly have been a purchase price adjustment ....\textsuperscript{592}

Furthermore, as Judge Stapleton noted in his Third Circuit dissenting opinion, section 108(e)(5) “necessarily applies only to a situation in which the debtor still holds the property acquired in the purchase money transaction.”\textsuperscript{593} As was explained by Professor Seto, section 108(e)(5) simply does not work in situations like Zarin where assuming arguendo chips constituted “normal commercial property;”\textsuperscript{594} he didn’t hold them at the time of settlement and thus there was no basis in property that could be adjusted.\textsuperscript{595} He explained why the debtor’s holding the property at time of settlement is critical for the statute to work properly.\textsuperscript{596} He indicated that the deferral mechanism [in section 108(e)(5) or its no-statutory counterpart] cannot operate unless the taxpayer still owns the property. If the taxpayer has already disposed of the property and has accounted for that disposition using the original higher basis, application of either purchase price adjustment exception will mismeasure the taxpayer’s income ....\textsuperscript{597}

\textsuperscript{592} See Shaviro, supra note 11, at 248. Professor Shaviro, however, recognized that [o]ne could draw the § 108(e)(5) line either way .... [b]ut if one wants to decide the case in Zarin’s favor, however, one may prefer to rely on the cancellation of indebtedness issue, because there the focus is directly on expected cost, rather than on the technical issue of what ‘property’ means for § 108(e)(5) purposes. \textit{Id.} at 249 (footnote omitted).

\textsuperscript{593} Zarin, 916 F.2d at 118 n.3 (Stapleton, J., dissenting).

\textsuperscript{594} \textit{Id.}

\textsuperscript{595} See Seto, \textit{supra} note 213, at 1789.

\textsuperscript{596} \textit{Id.}

\textsuperscript{597} \textit{Id.} Professor Seto reasoned that: In Zarin’s case, for example, Ruwe would apparently have allowed Zarin the $3.435 million in 1980 gambling losses—subject, of course, to the limitations of § 165(d)—because at the time Zarin lost the chips they had a basis equal to their original purchase price. Applying the statutory purchase price adjustment exception to exclude any debt discharge income, he would therefore ultimately have credited Zarin with $3.435 million of net losses even though Zarin was in fact out of pocket only $500,000. In other words, Ruwe would have mismeasured Zarin’s income.
The Third Circuit did not discuss section 108(e)(5) per se, but evidently found section 108 in its entirety inapplicable because it determined that there “was no indebtedness of the taxpayer” within the meaning of section 108(d)(1). As noted above, the conclusion vis-a-vis section 108(d)(1) was in error. In sum, the right decision with respect to section 108(e)(5) was reached, but for the wrong reason.

While the Tenth Circuit, in Preslar, suggested that the enactment of section 108(e)(5) preempted a non-statutory purchase-money debt reduction, absent clear language that Congress intended to displace this common law approach, the arguments of many commentators, including Professors Dodge and Gunn are persuasive that a court could have employed this approach for services in Zarin. Professor Dodge wrote that “[a] purchase-price reduction rule exists independently of the statute,

Id. at 1789–90. Another commentator, Douglas E. Kulper, also explained why section 108(e)(5) relief should not apply when the taxpayer is devoid of the property at settlement. See Kulper, supra note 345, at 642. He wrote that:

[P]urchase-money debt reduction occurs when a purchaser of property agrees to incur a debt to the seller, but the seller subsequently reduces the debt because the value of the property is less than the agreed consideration. Even assuming that the property requirement of section 108(e)(5) was met, a purchase price adjustment could not occur under the facts in Zarin. The purchase-money debt reduction involves three steps. First, the chips purchased are assigned a tax basis equivalent to the loan. In Zarin’s case, this would be $3,450,000 this should be $3,435,000. Second, the basis in the chips is reduced by the amount of purchase price adjustment, in this case $2,935,000. This would occur at settlement. Third, the buyer recognizes income from the purchase price adjustment when the property is sold or transferred. At that time, the amount received above the basis in the property becomes recognized income. In Zarin’s case, however, the basis in the property was zero at the time of the settlement. He extinguished the basis by using the chips for his gambling enjoyment. Because Zarin’s basis in the chips at the time of settlement was zero and Zarin no longer retained the power of transferability of the chips, a purchase price adjustment could not occur.

Id. at 639–40.

598 See Zarin, 916 F.2d at 113.
599 See supra Section II.E.
600 Preslar v. Comm’r, 167 F.3d 1323, 1332–33 (10th Cir. 1999).
601 See Gunn, supra note 422, at 895; Dodge, supra note 19, at 678.
where the purchase-money debt relates to consumption rather than an asset."602 If this writer correctly understood Professor Dodge, it was his opinion that the reasoning of the court should have been that the cost of the gambling services ought to have been adjusted downward to the $500,000 payment, since “there can be no debt-cancellation income where the consumption is purchased on credit in commerce and the debt is subsequently cancelled or settled.”603

Would this have been an appropriate analysis and outcome for Zarin? Professor Schenk’s opinion was that it would not have been suitable. She stated:

Whether the chips were property under § 108(e)(5) is a red herring. The real issue is whether the exception should apply when the debtor has received and used or consumed property worth the face amount of the debt when received .... [A] purchase price adjustment is inappropriate where it is the credit worthiness of the borrower that has changed and the borrower has fully enjoyed the entertainment or services. Other than the majority opinion in the Third Circuit, no one argued that Zarin did not enjoy $3.5 million of gambling. Certainly Resorts did not claim that one could pay less than $3.5 million. If I turned up at Resorts tomorrow and asked for $3.5 million in chips, chances are I would have to cough up $3.5 million.604

Zarin was not a circumstance where the taxpayer did not obtain the services he paid for.605 He obviously received the gambling services he incurred the debt for.606 There was certainly no understanding by the parties that he would be successful at it.607 Despite the foregoing, one should not be blindsided to what could be viewed as an inequity. Zarin was an unfortunate gambler, suffering from an addiction that was likely exploited by Resorts, and put in a position of owing the federal government millions of dollars on the settlement of his losses.608 While sharing the empathy of many writers for Zarin, this does not mean

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602 Dodge, supra note 19, at 678 (footnote omitted).
603 Id. at 683.
604 Schenk, supra note 12, at 166, 166 n.88.
606 See id.
607 See id.
608 See id. at 1086.
the federal tax law should be construed in such a manner as to carve out an exception for him, which is not consistent with the law with respect to COD income. To remedy what many might view as an injustice with respect to future Zarins (assuming the Third Circuit opinion is not followed), Congress could, as Professor Barton suggested,\(^\text{609}\) amend the Code. In addition to or in lieu of carving out a special exception in section 108, this might include modifying section 165(d) to allow COD income from settling a gambling related indebtedness to be offset by current or a prior year’s (or possibly years’) gambling losses.

Finally, a reviewer of an earlier draft of this Article posed a hypothetical along the following lines as to how far this writer would extend his reasoning with respect to Zarin. A homeowner loses his job during the COVID-19 pandemic and his local utility company agrees to reduce the customer’s electric bill by $200 from $300 to $100. Does the customer have $200 of COD income? There is a line of reasoning that he does. That is why not treat utility services and gambling services alike? There is, however, a contrary rationale. As discussed, this writer believes that Resorts should be treated as functioning as both a lender, making substantial loans, and a provider of gambling services.\(^\text{610}\) The settlement had the effect of reducing Zarin’s indebtedness to his financier, Resorts.\(^\text{611}\) This is why he should be taxed. The utility on the other hand is providing a service that it bills customers for after it is furnished, and it merely reduced the cost of this service. This is arguably not the equivalent of the two hats worn by Resorts in Zarin. There is a legitimate position not to treat all service suppliers billing their fees after its provision as being characterized as lenders, with the reduction or cancellation of the payable treated as COD income. In most of those circumstances, there is merit in Professor Dodge’s assertion that there should be “no debt-cancellation income where consumption is purchased on credit in commerce and the debt is subsequently cancelled or settled.”\(^\text{612}\) This writer would thus not extend his

\(^{609}\) See Barton, supra note 168, at 782.

\(^{610}\) See supra notes 555–62 and accompanying text.

\(^{611}\) See Zarin v. Comm’r, 92 T.C. 1084, 1088 (1989); Bittker & Thompson, supra note 49, at 1165.

\(^{612}\) See Dodge, supra note 19, at 683.
conclusion in Zarin to encompass all situations where a taxpayer’s obligation to a service provider is reduced or eliminated.613

CONCLUSION

While there are plausible arguments to the contrary, Zarin should have had been determined to have COD income from his settlement with Resorts.614 Zarin was not subject to tax when he received the gambling credit because both parties had, at the time the indebtedness was incurred, an understanding that it would be repaid.615 This tax benefit he received at the time of the loans results in COD income upon the indebtedness’ settlement for less than what was owed, unless an exception applied, and none should have in this case.616

The loan proceeds methodology, or a variation thereof, is the proper means of establishing whether a taxpayer has COD income, prior to considering whether any of the exceptions apply.617 Both the freeing of assets and the Kerbaugh-Empire form of the whole transaction concepts should no longer be followed by the courts.618

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613 But see Musselman, supra note 6, at 634–35. Although he would not have taxed Zarin on all or at least part of the reduction to his liability, based on his tax accountant preparation hypothetical discussed above, he would likely treat the $200 as COD income.

614 See supra Section II.E; supra text accompanying note 569.

615 See supra notes 98–105 and accompanying text.

616 See supra notes 98–105 and accompanying text; see also McMahon & Simmons, supra note 3, at 437 (“[N]one of the exceptions to section 61(a)(12) or section 108 applied.”).

617 See supra Section II.E.

618 See Schenk, supra note 12, at 144 (discussing criticism of freeing of assets); see also Bittker & Thompson, supra note 49, at 1162–63 (discussing whole transaction theory and why it is defective).