Discharging Debt, Settling Litigation, and Singing the Blues

By Robert W. Wood

Robert W. Wood practices law with Robert W. Wood, P.C., in San Francisco (http://www.rwwpc.com). He is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. 2005), published by the Tax Institute and available at http://www.damageawards.org.

In settling litigation, practitioners understandably want to characterize the recovery in a favorable light from a tax perspective. Settling litigation usually involves compromises, and it is hardly unreasonable for parties to try to do a little tax planning at settlement time. That is all the more appropriate given that subtle distinctions in the tax law can mean the difference between income and no income, between ordinary income and capital gain, or between a deduction and no deduction.

Discharge of indebtedness income has long been one of those areas that every tax person understands, but clients too often don't. Conceptually, everyone does understand that one receives an economic benefit when an otherwise collectible debt need not be repaid. What clients sometimes don't appreciate is the income tax effect that results.

Although the repayment of a loan generally has no tax consequences, if a loan is forgiven, or discharged for less than the amount owed, the borrower must include in income the amount of the forgiveness or discount. However, section 108 provides that gross income does not include any amount that would otherwise be included in gross income by reason of discharge of indebtedness if the taxpayer is bankrupt or insolvent. Of course, like many provisions in the code, there are limits on the amount that can be excluded.

And if an amount is excluded from gross income under section 108, the taxpayer excluding the forgiveness of debt must also generally reduce specified tax attributes by the amount forgiven. Thus, in a sense, the insolvent or bankrupt taxpayer pays his tax by sacrificing future tax benefits.

Discharge of Debt and Litigation Recoveries

Given that the discharge of indebtedness rules of section 108 seem relatively straightforward, how are those rules affected when a debt is resolved in the context of litigation? The answer is going to depend a lot on the facts, but one exception to discharge of indebtedness income that springs to mind is the rule that disputed indebtedness does not trigger income.

In *Earnshaw v. Commissioner*,[1] the petitioner settled a dispute with his credit card company, MBNA. In doing so, the IRS found, and the Tax Court agreed, that the petitioner received unreported discharge of indebtedness

[1]2005 WL 2304960, *Doc 2005-19594, 2005 TNT 185-13* (10th Cir. 2005).

income. The petitioner claimed that the Tax Court erred in finding discharge of indebtedness income as a result of the settlement with MBNA. The taxpayer argued that because he disputed the amount owed on his credit card, the entire debt fell within the contested liability exception to discharge of indebtedness income. He pointed to the settlement of less than the entire amount MBNA claimed he owed as evidence of his position.

That argument is based on the notion that a discharged debt is not income if the taxpayer contests the original amount of an alleged debt in good faith. In *Preslar v. Commissioner*,[2] the court stated that ''a subsequent settlement'' of a disputed debt is treated as the amount of debt cognizable for tax purposes. Thus, ''in other words, the excess of the original debt over the amount determined to have been due may be disregarded in calculating gross income.''

The Tax Court in *Earnshaw* rejected the petitioner's claim that his entire credit card account balance constituted a ''contested liability.'' Instead, based on two written statements Earnshaw submitted to the credit card company, the Tax Court found that he did not dispute that he owed approximately $29,800 on his credit card. The court found that he incurred discharge of indebtedness income after accounting for some payments he made on his credit card in 1996, a cash advance he received using his credit card in 1996, and approximately $12,700 he paid to the credit card company in 1998 in settlement of his account.

However, the Tax Court provided some relief by finding that the petitioner had disputed some finance charges and late fees that MBNA assessed. As a result, the court determined that those amounts did not constitute discharge of indebtedness income under the contested liability doctrine. The Tenth Circuit agreed.

Gambling Debts

The contested liability doctrine was also asserted in the Third Circuit case of *Zarin v. Commissioner*.[3] Zarin was a resident of Atlantic City, N.J., and was a compulsive gambler. A local casino extended him a line of credit and over a two-year period increased his credit from $10,000 to $200,000. During that time, Zarin paid the casino more than $2.5 million in gambling losses. Responding to allegations of credit abuse, the New Jersey Division of Gaming Enforcement precluded the casino from extending Zarin any more credit. Despite that order, the casino continued to extend credit to him.

The casino finally cut the taxpayer off when he drew a check against insufficient funds in the amount of more than $3.4 million. The casino went to court to collect the $3.4 million, but Zarin argued that the debt was unenforceable based on state regulations intended to protect compulsive gamblers. The parties finally settled for $500,000. Of course, the IRS argued that Zarin had received more than $2.9 million of cancellation of debt income on settlement with the casino (the difference between the amount owed and the amount settled). The Tax Court agreed with the IRS, accepting the IRS's logic that the casino chips were equivalent to cash and that the chips were not treated as income at the time they were received. Thus, according to the Tax Court and the IRS, Zarin recognized an obligation of repayment.

On appeal, the Third Circuit analyzed whether the extension of credit actually represented a debt to the taxpayer. The code defines the term as any debt ''for which the taxpayer is liable'' or ''subject to which the taxpayer holds property.''[4] The Third Circuit determined that this was clearly not a debt for which the taxpayer was liable because the debt Zarin owed the casino was unenforceable under New Jersey law.

Further, the Third Circuit determined that the casino chips (which were provided to the taxpayer based on his line of credit) were not property in Zarin's hands or in the casino's hands. As a result, the court determined that the cancellation of indebtedness provisions of the code did not apply to the settlement between Zarin and the casino.

Zarin owed an unenforceable debt of $3.4 million to the casino. In good faith, he disputed his obligation to repay it, and the parties settled for $500,000, which Zarin paid. That $500,000 settlement fixed the amount of loss and the amount of debt cognizable for tax purposes. Because the taxpayer was deemed to owe only $500,000 and because he paid that amount to the casino, no adverse tax consequences attached to Zarin. Thus, the Third Circuit disagreed with the IRS and reversed the Tax Court's decision. The $500,000 settlement amount Zarin paid dissolved any further tax consequences.

Origin of the Contested Liability Doctrine

The contested liability doctrine can be traced to *N. Sobel Inc. v. Commissioner*,[5] a case that arose during the Great Depression. A New York corporation purchased 100 shares of a bank's stock and signed a $21,700 note as payment. When the note matured, the stock was worthless. The corporation sued the bank for recission, insisting that the loan contravened state law and arguing that the bank had failed to fulfill its promise to guarantee the corporation against loss. Soon after, the state superintendent of banks closed the bank because of insolvency and initiated a countersuit against the corporation for the amount of the note.

The parties ultimately settled the consolidated proceedings, with the corporation paying the superintendent $10,850 in return for discharge of the debt. The corporation then took a $10,850 deduction in the year of settlement. The IRS disallowed the deduction and assessed a $10,850 deficiency, representing the amount of the original loan over the settlement figure. The Board of Tax Appeals upheld the deduction, concluding that the corporation's ownership of the shares and the degree of liability on the note were unclear.

The Board of Tax Appeals found that the corporation's financial obligations could not be assessed definitively before resolution of its dispute with the superintendent.

[2]167 F.3d 1323, 1327, *Doc 1999-6438*, *1999 TNT 32-6* (10th Cir. 1999).

[3]916 F.2d 110 (3d Cir. 1990).

[4]Section 108(d)(1).

[5]40 B.T.A. 1263 (1939).

Because the settlement compromised the parties' claims and precluded recognition of their legal rights, the existence and amount of the corporation's liability were not fixed until the date of the settlement. Thus, the release of the note did not represent gain to the corporation.

The contested liability theory arose from the notion that when a taxpayer disputes the original amount of a debt in good faith, a subsequent settlement of that dispute simply determines the amount of the debt for tax purposes.

Waiving Indebtedness?

In *Waterhouse v. Commissioner*,[6] a former U.S. Marine attempted to argue that he should not be treated as having received cancellation of debt income when an amount determined to be owed by him was ultimately waived by the Veterans Administration (VA) (now the Department of Veterans Affairs). After sustaining serious injury in combat, the taxpayer was discharged from the Marine Corps and was compensated with disability benefits by the VA. During the years after his discharge, the taxpayer enrolled in art classes and became a skilled artist.

The Marine Corps contracted with the taxpayer to have him illustrate the history of the Revolutionary War. In lieu of retaining the taxpayer as an independent contractor (his services were too expensive), the Marine Corps suggested he join the reserves as a specialist officer. The taxpayer served as specialist officer for many years.

On joining the reserves, the taxpayer became ''active'' once again, thereby receiving active duty pay. On receipt of active duty pay, he became ineligible to receive disability compensation through the VA. Yet the disability compensation payments continued to be paid to him. The taxpayer was later informed that he was liable for repayment of the benefits he had received from the date of his commissioning in the Marine Corps Reserve.

The taxpayer applied for a waiver for repayment of the allegedly overpaid disability amounts, asserting several reasons why he should not be liable, including that there was no debt owed. The VA granted the taxpayer's application in January 1989, and the taxpayer was not liable for repayment. However, the VA failed to address whether the taxpayer had incurred a valid debt to repay the waived disability benefits he received during his time in the reserves. In a supplemental statement issued a month later, the VA determined that the taxpayer was indebted to the VA for the repayment of the disputed disability benefit payments. The VA reported the waiver of repayment as a discharge of indebtedness and as a taxable transaction.

The taxpayer continually appealed the VA's determination that the waiver was one of a debt and argued that he was not legally indebted to the government for any overpayment of disability benefits. In 1992, after three years of appeals, the VA reached a final conclusion and dismissed the taxpayer's appeal. The IRS sought to collect tax on the cancellation of debt income received by the taxpayer as a result of the waiver to repay the disability compensation. In the Tax Court, the taxpayer argued that he was not legally indebted to the VA in 1989, the year it initially determined indebtedness, and that the waiver of repayment was a gratuitous nontaxable discharge of indebtedness. The Tax Court dismissed the taxpayer's arguments and sided with the IRS.

The Tax Court dispensed with the taxpayer's first argument that there was no indebtedness in 1989 by stating that the identifiable event that established the indebtedness occurred in 1989 when the VA granted the taxpayer a waiver of repayment. The Tax Court thus determined that the timing of inclusion (that is, 1989 or 1992, the year the indebtedness was finalized) was not a question. It found that the only issue before it for adjudication was whether there was a valid debt to be discharged. As stated above, the court found the indebtedness was real.

The court also determined that the taxpayer's contention that the waiver was gratuitous in nature was unfounded, stating that the VA did not act toward the taxpayer with a detached and disinterested generosity arising from respect, admiration, charity, or similar impulse or motive. Interestingly, the taxpayer cited to LTR 8839026, in which the VA granted a taxpayer a waiver from indebtedness based on the general welfare exception. That taxpayer therefore incurred no cancellation of debt income from the waiver of repayment.

Although the facts of the private letter ruling were admittedly different from the facts in *Waterhouse*, the *Waterhouse* court did not analyze the two fact patterns to distinguish the letter ruling from its own set of facts. The Tax Court just stated that the taxpayer in *Waterhouse* could not rely on a private letter ruling for precedent, even though both taxpayers received waivers of repayment to the VA.

House of Blues

Finally, I want to turn to tax deduction issues arising out of debt payments and to a recent case worthy of note concerning that flip side of the debt discharge income issues. The case is *Tigrett v. U.S.*[7] I say it involves the flip side of the debt discharge income issue because it involved indemnification issues (and the denial of a deduction for same). Because the indemnity arose out of debt, I think it's worth examining. Besides, it has a plot worthy of a made-for-TV movie.

The case involved a business aptly named House of Blues. It was a restaurant venture started by Mr. Tigrett and was housed in a corporate entity called House of Blues Entertainment. Mr. Tigrett did not own a controlling interest in House of Blues but was an employed chief executive. His contract provided that if he failed to generate profits for the company for any fiscal year ending after December 31, 1996, the company could fire him.

In early 1996 the company sought to capitalize on an additional location in Atlanta to take advantage of the

[6]T.C. Memo 1994-467, *Doc 94-8633, 94 TNT 187-6*.

[7]96 AFTR2d 2005-5649, *Doc 2005-17806, 2005 TNT 166-12* (W.D. Tenn. 2005).

Olympic Games scheduled for Atlanta. The company's board was concerned that the venture might fail, and, to push it through, Tigrett and two other board members agreed to cover any shortfall. The agreement was not intended to be a loan to the company, and Tigrett received no additional shares, stock options, or other securities in exchange for his indemnity agreement. The company thereafter advanced nearly $7 million to open the Atlanta venue, providing all capital and anticipating that the funds would be repaid either from profits or, in the worst case, under the indemnity agreement.

The bomb at the Olympics closed the restaurant for 4½ days, and that, possibly along with other factors, caused the company to lose $10 million from the Atlanta venue. Tigrett dutifully stepped forward to honor his indemnity agreement, pledging his shareholdings as well as options in the company to a third party, Parkway Hotel Corp., in exchange for a $5 million loan. He paid the $5 million to House of Blues.

Despite that effort, Tigrett was still terminated in October 1997. He continued to own the shares and options he pledged to Parkway. Although he transferred his shares in consideration for Parkway's forbearance from enforcing its loan rights, Tigrett never made any payments as principal or interest on the underlying loan.

Tigrett claimed a $5 million tax deduction for the payment made to House of Blues, asserting that:

- it represented a business bad debt under section 166;
- it represented an ordinary and necessary business expense under section 162; or
- it was a loss incurred in operating a trade or business under section 165.

The IRS disagreed with all three theories, and the district court set to resolve the question.

Worthless Debt

For Tigrett to be able to deduct a debt as worthless, there must be a valid debt. Also, the debt must be created or acquired in connection with a trade or business. Then the amount of the debt must be established, its worthlessness must be fixed, and one must be able to tell in which tax year the debt became worthless.

The IRS struck hard, saying that there was no underlying debt and that Tigrett instead merely made a capital contribution. The IRS also asserted that there was no proximate relationship between the debt (if it could be called a debt) and Tigrett's trade or business. After all, Tigrett's dominant motivation, said the IRS, was investment-related, not in furtherance of his interest as an employee of House of Blues.

The court didn't have to delve too far to find that it agreed with the IRS's strict view. Relying on *Roth Steel Tooth Co. v. Commissioner*,[8] the court concluded that Tigrett made a capital contribution, not a loan. There was no promissory note, so no separate instrument evidencing the debt, no fixed maturity dates or schedule of payments, and no stated interest rate (nor evidence that interest payments were ever made) existing to support the taxpayer's position that there was debt.

Business Expense Deduction

Normally what constitutes an ordinary and necessary business expense is relatively easy to determine. The standards for ''ordinary'' are lax, and even ''necessary'' is given wide berth. Unfortunately, here the district court found no evidence to show that it was common in the restaurant or entertainment business for an officer of a company to make a personal guarantee in an amount several times his annual salary to encourage the company to undertake a new venture. The primary benefit of the indemnity, the court found, was to build interest in the House of Blues brand before a public offering of shares. Those expenditures, according to the court, had to be viewed as capital.

Loss Deduction

Knocking over Tigrett's third argument, the court found that the payment under the indemnity agreement was voluntary and thus not eligible for a deduction under section 165. In many ways, that finding by the court was the unkindest cut of all. After all, the court agreed that Tigrett was engaged in the trade or business of developing and promoting restaurants and entertainment venues. Unfortunately though, the court found that although Tigrett did pay the company under his indemnity obligation, he made the payment voluntarily.

Tigrett made the payment under an agreement to do so (and that doesn't sound voluntary), but the court found no separate consideration for that agreement. He didn't receive additional shares, he didn't receive an extended employment contract term, and so forth. The court found that he could not personally profit from his indemnity obligation, so there was no loss deduction allowable under section 165(c)(1).

Fixing the Blues?

Perhaps it isn't fair to play Monday morning quarterback to Tigrett's blues. However, a couple of points seem obvious. Had the company demanded the indemnity payment and asserted a claim for it, the payment might have been deductible under section 165. Similarly, had there been documents suggesting that the employment contract was renegotiated in some respects at the time the indemnity payment was made, there might have been consideration to support the deduction.

I think the section 162 issue is a tougher one, given Tigrett's status as an employee. Yet, even the business bad-debt argument would have had a chance of flying had the debt been thoroughly documented as a loan. Here it smacked too much of capital.

Conclusion

Settling a lawsuit often — if not always — involves tax considerations. It is important for litigants and their counsel to be aware that discharge of indebtedness will generally be treated as income to the relieved debtor. A litigant may achieve some economic relief by being released from all or a portion of the debt he otherwise owes, yet tax law generally translates debt relief into income and subjects the person afforded relief to income tax on the amount forgiven.

Although there are exceptions and nuances to that complex rule (such as the contested liability theory), a taxpayer generally will be unable to escape tax liability

[8]800 F2d. 625 (6th Cir. 1986).

related to cancellation of debt. That means it's worth considering the contested liability theory before settlement time and using its get-out-of-jail-free card when appropriate. And although there are fewer concerns for creditors in those cases than for debtors, it is worth paying attention to the discharge of debt and satisfaction of debt rules even if you are a defendant paying settlement money, so you don't end up paying a settlement that you can't deduct. All of those principles should be kept in mind, because they may affect the terms of any settlement ultimately entered into by a litigant.