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Preslar v. Commissioner: Debt-Discharge Income and its Rationale

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Preslar v. Commissioner: Debt-Discharge Income and Its Rationale

I. INTRODUCTION

How taxpayers determine the amount of money on which they must pay taxes is an uneasy question because this amount, gross income, has never been conclusively defined. Neither the Internal Revenue Code ("I.R.C." or "Code") nor the courts have ever exactly defined the concept,[1] largely because the inquiry into what constitutes gross income involves numerous conceptual uncertainties. One of these uncertainties revolves around "[i]ncome from discharge of indebtedness."[2] The general notion of debt-discharge income (that a taxpayer recognizes a benefit and, therefore, must recognize income when a debt is forgiven because the taxpayer will not have to repay the debt) is relatively uncontroversial. However, there is considerable difficulty surrounding both the actual reasoning behind the rule and, more specifically, an exception to the rule that allows non-inclusion if the original amount of the debt is uncertain.

In the case of *Preslar v. Commissioner*, the Tenth Circuit examined this "disputed debt" exception in depth and came to a conclusion directly at odds with preexisting Third Circuit authority.[3] This Note analyzes these opposing conclusions and ultimately suggests that this split arises because the two circuits interpret the underlying logic of debt discharge income differently. Part II more thoroughly introduces the concept of debt-discharge income and examines the disputed debt exception to the general rule. Part III examines the facts of the *Preslar* case and summarizes the Tenth Circuit's reasoning. Part IV analyzes the court's reasoning in the context of how the rationale for debt-discharge income should affect the disputed debt exception and critiques the Tenth Circuit's application of the exception to the facts of the *Preslar* case. Finally, Part V concludes that the *Preslar* court correctly analyzed the concepts of debt-discharge in-

1. *See* 26 U.S.C. § 61 (1994); United States v. Gotcher, 401 F.2d 118 (5th Cir. 1968); James v. United States, 366 U.S. 213 (1961).

2. § 61(a)(12).

3. *See* Preslar v. Commissioner, 167 F.3d 1323 (10th Cir. 1999).

come and the disputed debt exception but incorrectly applied those concepts to the facts of the *Preslar* case.

II. BACKGROUND

A. Gross Income

When Great Britain first considered the adoption of an income tax, economists differed as to what amount should constitute a tax base.[4] Based on the ideal that people should be taxed according to their standard of living, some favored taxing personal consumption.[5] Others thought that people should be taxed according to their ability to pay and favored taxing wealth.[6] For a variety of reasons, an income tax was seen as a good way to attain both of these goals.[7]

Still, "income" had to be defined. The "Schanz-Haig-Simons" theory attempts to do this.[8] Although the theory does not explicitly appear anywhere in the I.R.C., this concept roughly describes the tax system's view of gross income.[9] In essence, it asserts that "an individual's income for a given period (usually a year) equals any net increase in her wealth (or minus any net decrease in her wealth) plus the market value of her consumption during the year."[10] Though the concepts of consumption and wealth change may seem easily comprehensible, both can be quite difficult to accurately ascertain. For example, consumption literally means any type of satisfaction, whether psychological or material; under this strict interpretation, a taxpayer's gross income should include both tangible and intangible benefits including, for instance, the enjoyment he receives from listening to birds sing.[11] Clearly, the Internal Revenue Service ("IRS")

4. *See* JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 30 (2d ed. 1999).

5. *See id.* at 30–31.

6. *See id.* at 31.

7. *See id.*

8. *See id.*

9. *See id.*

10. *Id.* The federal income tax system gets to this amount, more or less, by including all current year receipts less any business and investment deductions. Because the nondeductible receipts must either be consumed or saved, this approach carries out the Schanz-Haig-Simons concept. *See id.* at 34–35.

11. *See* Daniel Shaviro, *The Man Who Lost Too Much:* Zarin v. Commissioner *and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215, 224 (1990).

could not feasibly administer this interpretation. Instead, the IRS has chosen to value consumption objectively by only assessing a tax on the amount the taxpayer initially pays for consumption.[12] This practice helps, in large part, to simplify the tax system, and the conceptual tax base may again seem simple to compute. However, taxpayers engage in so many varied transactions that deciding whether a particular transaction is consumption or an increase in wealth or neither is very difficult.

The Supreme Court touched upon these difficulties in *Commissioner v. Glenshaw Glass Co.*,[13] a seminal case on the question of gross income. In *Glenshaw*, the Supreme Court had to determine whether a taxpayer who received a large award of exemplary damages had to include this "windfall" in gross income.[14] Feeling compelled to use a "liberal construction"[15] in applying the 1939 Code (the predecessor to the current code), the Court held that the windfall must, indeed, be included in gross income.[16] In so holding, the Court implicitly overruled an earlier, narrower interpretation of gross income in favor of this inclusive catch-all definition of "all gains except those specifically exempted."[17]

Understanding that the Court has approached the difficulties of defining gross income with a wide mandate of inclusion is important because it colors how courts look at all aspects of the system. With such broad ideals as consumption and wealth, many questions can and do arise, and the courts have great leeway in interpreting and deciding these questions. The Supreme Court's decision in *Glenshaw* had an umbrella effect over every ambiguous aspect of the system,

12. *See id.* at 225. The IRS accomplishes this, not by determining what everyone paid for everything, but by not allowing taxpayers to deduct from their gross income these types of expenses. For example, assume Jack makes $10,000 a year. He has business expenses totaling $1000. He has personal expenses totaling $5000 (spent on all the things people buy for their personal lives). The IRS does not require Jack to keep track of every personal expense so that they know how much to tax him (clearly, an administratively daunting task); instead the IRS requires Jack to include all $10,000 of his income, then allows deductions only for business expenses. Personal expenses are treated as a matter of nondeduction. *See* DODGE ET AL., *supra* note 4, at 53–54.

13. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

14. *See id.* at 427, 429.

15. *Id.* at 430.

16. *See id.* at 429 ("This Court has frequently stated that. . .[the language defining gross income] was used by Congress to exert . . . 'the full measure of its taxing power.'" (quoting Helvering v. Clifford, 309 U.S. 331, 334 (1940))).

17. *Id.* at 430; *see also* DODGE ET AL., *supra* note 4, at 62.

instructing the courts to broadly enforce the tax code, instead of narrowly interpreting it.[18]

B. Debt-Discharge Income

Even before the Court adopted *Glenshaw*'s broad approach, it decided that taxpayers must include the amount of a discharged debt in gross income.[19] In *United States v. Kirby Lumber Co.*, the Supreme Court held that if a "'corporation purchases and retires any . . . bonds at a price less than the issuing price or face value, the excess of the issuing price . . . over the purchase price is . . . income for the taxable year.'"[20] The Court apparently limited the scope of its holding by stating that Kirby Lumber Company had to include the amount of reduced debt in its gross income because the reduction of debt had "made available . . . assets previously offset by the obligation of bonds now extinct."[21] This language suggested that debt-discharge income had to be included only "to the extent that it freed the borrower's assets."[22]

This "freed assets" justification for debt-discharge income seems rather intuitive. At the beginning of the transaction, loan proceeds were encumbered and did not realistically belong to the taxpayer; as such, he did not have to include them in gross income.[23] In hindsight, after the debt discharge, the loan proceeds are free and clear,

18. In *Glenshaw*, the Court recognized that Congress had "applied no limitations as to the source of taxable receipts." 348 U.S. at 429. As such, the Court felt compelled to recognize congressional intent and give wide latitude as to what items should be included in gross income. *See id.* at 430.

19. *See* United States v. Kirby Lumber Co., 284 U.S. 1 (1931). At the time of *Kirby*, before *Glenshaw*, the Court did construe debt-discharge income a bit more narrowly than they now do. The Court cited an earlier case, *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926), for the proposition that a transaction could yield debt-discharge income only if the whole transaction was not a loss. *Kerbaugh-Empire*, however, has been largely discredited and a transaction can now yield debt-discharge income even though the transaction as a whole yielded a loss. *See* William Helburn, Inc. v. Commissioner, 214 F.2d 815, 819 (1st Cir. 1954) (stating that *Kerbaugh-Empire* is a "frequently criticized . . . decision."); DODGE ET AL., *supra* note 4, at 137 ("[T]he taxpayer [is not] asked (as suggested by the *Kerbaugh Empire* case. . .) if the borrowed money is still wholly 'intact . . . .'").

20. 284 U.S. at 3 (quoting Article 545(1)(c) of Regulations 62, under Revenue Act of 1921).

21. *Id.*

22. Gregory M. Giangiordano, *Taxation—Discharge of Indebtedness Income—*Zarin v. Commissioner, 64 TEMP. L. REV. 1189, 1192 (1991).

23. *See* DODGE ET AL., *supra* note 4, at 133.

and the taxpayer can do anything he wants with them. It seems clear that he should now include the "newly acquired assets" in his gross income.

The Supreme Court, though, in *Commissioner v. Tufts*, seemed to move away from the freed assets justification.[24] In *Tufts*, the taxpayer owned property that was subject to a nonrecourse mortgage (an obligation for which he was not personally liable).[25] The taxpayer transferred the property to a buyer, and the buyer assumed the nonrecourse debt.[26] The Court held that the taxpayer realized income equal to the amount of the discharged mortgage.[27] The Court did not look at whether the discharge freed any of the taxpayer's assets; instead, it focused on the *symmetry*[28] of the loan transaction.[29] 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.[30] 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."[31] 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.

24. *See* 461 U.S. 300 (1983); Shaviro, *supra* note 11, at 218.

25. *See* 461 U.S. at 302.

26. *See id.* at 303.

27. *See id.* at 308–09. The decision is more complicated than just that: income is not wholly defined by the amount of the mortgage discharge, and the case also deals with issues concerning how the income is recognized. For our purposes, though, the case stands for the proposition that discharge of nonrecourse debt can result in income to the taxpayer. *See* DODGE ET AL., *supra* note 4, at 168–70.

28. *See infra* Part IV.A.2.

29. *See Tufts*, 461 U.S. at 309–10.

30. *See id.* at 307.

31. *Id.* at 310.

Tufts changed the rationale for debt-discharge income. No longer is a debt discharge included in income only when it frees assets. Under *Tufts*, all debt discharge becomes income when the debt was originally excluded from income. This shift does not destroy the concept of the disputed debt exception. However, it does change the basis for the concept, and that change has a very real effect on the application of the rule and its exceptions.

C. The Disputed-Debt Exception

In *N. Sobel, Inc. v. Commissioner*, the United States Board of Tax Appeals created an exception to the concept of debt-discharge income.[32] In *Sobel*, a corporation bought one hundred shares of stock from its bank with a note of credit.[33] When the note came due, the corporation refused to pay and brought suit, demanding rescission of the note and judgment for the interest paid.[34] The corporation claimed that the transaction was illegal and that the bank had failed to live up to its duties; the parties settled for half the original amount of the note.[35] The IRS contended that the corporation had to include the half that had been settled away in its gross income.[36] The court held that, since there was "question . . . as to . . . [the taxpayer's] liability and the amount thereof," the IRS could not definitively say that the discharge had actually freed any of the taxpayer's assets.[37] In other words, until the settlement, the debt "was not actual and present by any practical test."[38] Since the amount of debt was unknown, the taxpayer could not be taxed on a forgiveness of it.

Under the freeing of assets test, a debt is sufficiently "in dispute" if it is either unenforceable *or* unliquidated (the actual amount of the original debt is unknown). After all, one cannot free an already-freed asset—if the debt was always unenforceable, the asset was always free.

32. *See* 40 B.T.A. 1263, 1265 (1939). Though this case was decided before the Supreme Court adopted the symmetry rationale, the exception survives today. *See* Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990). However, it is my contention that the shift in rationale for the inclusion of debt-discharge income should be accompanied by a shift in the rationale and, hence, the application of the disputed debt exception.

33. *See* 40 B.T.A. at 1264.

34. *See id.*

35. *See id.*

36. *See id.*

37. *Id.* at 1265.

38. *Id.*

The Third Circuit, in *Zarin v. Commissioner*, applied the freeing of assets test to an unenforceable debt.[39] In this case, Zarin had run up considerable debt to a casino; under state law, however, the debt was unenforceable.[40] The casino and Zarin eventually settled their debt out of court for an amount considerably lower than what Zarin actually owed.[41] The IRS contended that this represented debt-discharge income. Zarin claimed that, because he disputed the debt, the disputed-debt exception applied and he did not have to include the discharged amount in gross income. The IRS countered that the exception applied only to an unliquidated debt.[42] The Third Circuit explicitly rejected the IRS's position and held that, "[w]hen a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute."[43]

The Tenth Circuit's decision in *Preslar* created a split on this point.[44] In *Preslar*, the Tenth Circuit rejected *Zarin* and stated that "[t]o implicate the [disputed debt] . . . doctrine, the original amount of the debt must be unliquidated."[45] Thus, the Third Circuit will invoke the disputed-debt exception when the original debt is either unenforceable *or* unliquidated, and the Tenth Circuit will invoke the exception *only* when the original amount is unliquidated.

III. *PRESLAR V. COMMISSIONER*

A. Facts

In 1983, Layne Preslar and his wife, Sue, purchased a 2500 acre ranch near Cloudcroft, New Mexico for one million dollars.[46] The Preslars financed the entire amount by executing a promissory note, secured by a mortgage on the ranch, in favor of Moncor Bank.[47] The Preslars intended to develop part of the ranch by subdividing 160 acres and selling one- or two-acre lots; the rest of the land was to be

39. *See* 916 F.2d 110, 116 (3d Cir. 1990).
40. *See id.* at 112.
41. *See id.*
42. *See id.* at 116.
43. *Id.*
44. *See* Preslar v. Commissioner, 167 F.3d 1323, 1328 (10th Cir. 1999).
45. *Id.*
46. *See id.* at 1325.
47. *See id.*

for hunting and other outdoor activities.[48] The plan enjoyed some success, and the bank allowed the Preslars to pay their note installments by assigning the sales contracts from lot purchasers to Moncor Bank at a discount.[49]

In August 1985, Moncor Bank was declared insolvent, and the Federal Deposit Insurance Corporation ("FDIC") was appointed receiver and took over the bank's operations.[50] The FDIC refused to accept the assignment of sales contracts as payment on the Preslars' note and ordered the Preslars to stop selling lots.[51] The Preslars sued, claiming that the FDIC breached their contract. The parties settled out of court, with the FDIC agreeing to accept $350,000 in full satisfaction for the Preslars' debt.[52] This represented a $449,463 reduction of the Preslars' outstanding debt; they did not include this amount in their gross income.[53] The IRS audited the Preslars and determined that they had underreported their gross income by not including the amount of the discharged debt.[54]

The Preslars took their case to the United States Tax Court, claiming that they were exempt from including the amount in their gross income by 26 U.S.C. § 108(e)(5) (1994).[55] The Tax Court ignored the Preslars' section 108 claim but ruled in their favor by invoking, sua sponte, the disputed debt exception.[56] It held that the amount of the Preslars' debt was not firmly established until the settlement actually occurred; hence, they did not have any debt-discharge income.[57] The IRS appealed to the Tenth Circuit Court of Appeals.[58] The Tenth Circuit overturned the Tax Court, holding that the Preslars did have to include the debt-discharge amount in

48. *See id.*

49. *See id.*

50. *See id.*

51. *See id.* at 1325–26.

52. *See id.* at 1326.

53. *See id.*

54. *See id.*

55. *See id.* Pursuant to § 108(e)(5), under certain circumstances a seller's reduction of a buyer's outstanding debt may be exempted from debt discharge income treatment. Though this section is an important caveat to the general rules of debt discharge income, it ultimately has no real bearing on this case or this note.

56. *See id* at 1326.

57. *See id.*

58. *See id.*

their gross income because the disputed-debt exception could not be applied to a liquidated debt.[59]

B. Reasoning

The Tenth Circuit agreed with the IRS and found that the amount of the Preslars' debt discharge fell within the definition of gross income and, more specifically, within the scope of 26 U.S.C. § 61(a)(12).[60] The court then discussed both the free assets and symmetry rationales for the debt-discharge income rule. The court cited the Supreme Court case of *Commissioner v. Tufts*[61] and, without explicitly saying so, adopted the symmetry justification.[62]

Moving to an analysis of the disputed-debt exception, the court stated that the exception "rests on the premise that if a taxpayer disputes the *original amount* of a debt . . . , a subsequent settlement of that dispute is 'treated as the amount of debt cognizable for tax purposes.'"[63] The court also examined the seminal case of *N. Sobel, Inc. v. Commissioner*.[64] It construed *Sobel* as allowing for nonrecognition because in that case the "corporation's financial obligations could not be assessed . . . [because] the existence *and* amount were not fixed until the date of settlement."[65] This interpretation seems to require that the amount be unliquidated.

The court then looked at *Zarin* and baldly stated that the Third Circuit incorrectly found that an unenforceable debt is unliquidated.[66] The Tenth Circuit held that treating liquidated and unliquidated debts alike is incorrect because "[t]he 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 . . . [IRS] unaware of the exact consideration ini-

59. *See id.* at 1328.

60. *See id.* at 1333.

61. 461 U.S. 300 (1983).

62. *See Preslar*, 167 F.3d at 1327–29.

63. *Id.* at 1327 (quoting Zarin v. Commissioner, 916 F.2d 110, 115 (3d Cir. 1990)). Undoubtedly, the Third Circuit would feel that relying on *Zarin* for this proposition was, at least, disingenuous. The Tenth Circuit took a small quote out of context to support a proposition that *Zarin* explicitly rejects. *See supra* text accompanying notes 29–33.

64. *See* 40 B.T.A. 1263 (1939).

65. *Preslar*, 167 F.3d at 1328 (emphasis added).

66. *See id.*

tially exchanged in a transaction."[67] The court's sole authority for this specific rationale was a single law review article.[68] The article, in turn, relied on nothing; it suggested, in and of itself, that a taxpayer can utilize the disputed debt exception only when the IRS does not know the amount of debt initially excluded from gross income. In other words, this is merely an administrative requirement meant to allow the IRS to simplify its auditing processes so that it does not have to investigate every unliquidated debt.[69] It seems that the court was, on its own, creating a new justification for the debt-discharge rule.

However, the court immediately solidified its position by also adopting the established symmetry rationale. The court stated that, "'[i]f the parties initially treated the transaction as a loan when the 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.'"[70] The court, somewhat secondarily, added that this symmetry rationale is "underscored" by *Tufts* because the Supreme Court found that if "indebtedness is treated as a true debt when . . . incurred, it must be treated as a true debt when . . . discharged."[71] The court further reasoned 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."[72] The court seemed to minimize this justification; however, since this is the only place where the court solidly relied on any precedent; this was really the heart of the court's reasoning.

67. *Id.*

68. *See id.* (relying on Shaviro, *supra* note 11, at 256).

69. *See* Shaviro, *supra* note 11, at 256. This is not to suggest that the IRS cannot, or should not, make rules based on administrative decisions. *See* Haverly v. United States, 513 F.2d 224, 227 (7th Cir. 1975) (holding that "[i]t is not for the courts to quarrel with. . .[the IRS's] rational allocation of its administrative resources"). This is merely pointing out that the Tenth Circuit, so cavalier in shooting down its sister circuit, is here apparently relying not on established precedent or authority but merely on a proposed justification from a law review article.

70. *Preslar*, 167 F.3d at 1329 (quoting Giangiordano, *supra* note 22, at 1200 n.88). The court also relied on *Glenshaw* for this proposition by stating that any other interpretation (i.e., the free assets rationale) would "disavow the Supreme Court's mandate that the phrase 'gross income' be interpreted as broadly as the Constitution permits." *Id.*

71. *Id.* (relying on Commissioner v. Tufts, 461 U.S. 300, 311–13 (1983)).

72. *Id.*

The court went on to undercut *Zarin*'s reliance on one of the Tenth Circuit's cases. *Zarin* relied on *United States v. Hall*, a gambling debt case remarkably similar to *Zarin*.[73] In *Hall*, the Tenth Circuit found that the taxpayer did not have income when he settled a gambling debt for less than its "face" amount because the debt, "being unenforceable . . . [did] not meet the requirements of debt necessary to justify the . . . operation of general rules of tax law relating to cancellation of debt."[74] The Tenth Circuit reasoned that *Hall*'s emphasis on unenforceability made the case questionable in light of *Tufts*, and, even if *Hall* were still good law, *Zarin*'s reliance was misplaced because the debt in *Hall* was unliquidated. Even in *Hall*, the symmetry rationale, not the freed assets approach, underlies the decision.

The court then moved to the specific facts of *Preslar*, holding that the Tax Court had incorrectly found the amount of the Preslars' debt unliquidated. The Tenth Circuit found no evidence to support the Preslars' contention that the amount of the debt was in dispute. The court reasoned that, since there was no competent evidence showing that the FDIC had to observe the previous creditor's practice of accepting assignment of sales contracts as payment on their note, there was no good faith disagreement over how much the note was worth. The court continued that, even if there were a good faith disagreement, the disagreement pertained only to the terms of repayment not to the actual amount of the debt. There being no evidence of a good faith dispute over the *amount* of the debt, the disputed-debt exception could not be invoked to surpass the debt-discharge income rule.[75]

IV. ANALYSIS

The *Preslar* court got the law right, but it came to the wrong conclusion only because it incorrectly applied the law to the facts. The Tenth Circuit was right about applying the disputed-debt exception because it correctly analyzed and applied the underlying debt-discharge income rule. The Third Circuit, on the other hand, was wrong because it incorrectly construed the underlying tax law too broadly.

73. United States v. Hall, 307 F.2d 238 (10th Cir. 1962).

74. *Id.* at 241.

75. *See Preslar*, 167 F.3d at 1330–31.

A. Reasoning Behind the Debt-Discharge Income Rule

Intuitively, it seems clear that taxpayers should have to include debt-discharge in gross income. If someone were to work as a parking attendant, save up $5000 and buy a new car with the money, she would have effectively been taxed on the consumption that the car represents because she had to pay taxes on the $5000 when she earned it.[76] Similarly, if someone were to borrow $5000 from an off-shore bank and buy a car, he would effectively have to pay taxes on the consumption the car represents because he would have to repay the debt with after-tax dollars. If, however, the off-shore bank were to go bankrupt and forgive the borrower's debt, he would have $5000 of consumption (through the purchase of the car), but he would have it tax-free because he would no longer have to repay the debt with after-tax dollars. This seems unfair. The concept of debt-discharge income addresses this concern. As stated above, the reasoning behind this judicially created rule of income has changed since its first inception.[77] This change is important to the *Preslar* case, and to the circuit split it recognizes, because a rule's reasoning should directly affect how courts construe and apply any exceptions to that rule.

1. Freeing assets

The first justification for the debt-discharge rule, established in *Kirby Lumber*, was the freeing assets construct.[78] Under this approach, debt-discharge income constituted part of a taxpayer's gross income when a creditor discharged a debt, thereby freeing some asset of the debtor. This makes sense because, as in the above example, we do not want some people, through sheer luck, to enjoy consumption tax-free while others pay taxes on identical consumption. This approach feels equitable because it appears to take care of what seems unfair: by taxing people when an asset is freed through loan-forgiveness, the IRS ensures that those taxpayers do not arbitrarily receive tax-free consumption.

76. *See* 26 U.S.C. § 61(a)(1) (1994).

77. *See supra* text accompanying notes 15–23.

78. *See* United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931).

As previously stated, the Supreme Court created the freed assets justification in *United States v. Kirby Lumber*.[79] This justification, however, arises entirely from one sentence of dicta.[80] The Court cited no cases, statutes, legislative history, or anything else for this proposition; it seemed to rely only on the apparent fairness of the idea. That is not to say that, because it was "only" Supreme Court dicta, it had no effect. Indeed, until some superseding Court reasoning came along, it was the controlling rationale, and all courts should have bound themselves to defining debt-discharge income in accordance with the Court's stated justification. Superseding dicta did, however, come along in *Tufts*.[81]

2. Symmetry

As already described, *Tufts* abandoned the freed assets approach.[82] The Supreme Court did so by ignoring 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)[83] and instead focusing on whether an untaxed discharge transaction would mean that "the mortgagor effectively will have received untaxed income at the time the loan was extended."[84]

This 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). For example, assume Jack borrows $10,000. He and his creditor reach some kind of arrangement where Jack is personally liable for only $7000. Before

79. *See id.* at 1.

80. *See id.*

81. *See* Commissioner v. Tufts, 461 U.S. 300 (1983).

82. *See supra* Part II.B.

83. Previously, a nonrecourse mortgage was included in income because the Court assumed that the taxpayer would repay the debt with after-tax dollars. The logic of this assumption, though, applied only when the market value of the underlying asset exceeded the amount of the mortgage (because only then would the taxpayer have the rational incentive to actually pay the debt instead of allowing it to lapse and the creditor to take an asset worth more than the debt). The Court specifically left open the question of whether the taxpayer would have to include the discharged amount of the nonrecourse mortgage in gross income when the amount of the debt exceeded the fair market value of the underlying property (thereby leaving a rational seller with no incentive to repay the debt). *See* Crane v. Commissioner, 331 U.S. 1, 14 (1947); DODGE ET AL., *supra* note 4, at 158–60.

84. *Tufts*, 461 U.S. at 310.

the debt comes due, Jack's creditor permanently leaves the country, effectively discharging Jack's debt. Under the freed assets approach, Jack realizes $7000 of debt discharge income because it is only to that extent that his assets were encumbered (by his personal obligation). Under the symmetry analysis, though, all that matters is the amount that Jack initially received. The focus is on ensuring that, in the end, Jack is taxed on the amount that he received in the beginning.

Though 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.[85] When 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.

One may counter that *Tufts* does not extend this far by claiming that a nonrecourse mortgage is indeed enforceable to some extent.[86] However, the Supreme Court, in *Tufts*, did not say that the seller realized gain *only* to the extent that the seller had some liability in the property. On the contrary, the Court specifically held that it does not matter whether the "amount of the nonrecourse mortgage exceeds the value of the property transferred."[87] The seller realizes gross income to the full extent of the mortgage, no matter to what extent it is enforceable against him. This specific reasoning, along

85. One weakness in this theory is found in footnote 11. Here, the Court stated that "[w]e are not presented with and do not decide the contours of the cancellation-of-indebtedness doctrine. We note only that our approach does not fall within certain prior interpretations of that doctrine." 461 U.S. at 311 n.11. This language seems to constrain the symmetry approach to the particular issue of treatment of nonrecourse debt, precluding application to the general principle of debt-discharge income. However, this language applied to how the competing rationales relate to the application and characterization of basis. *See* Rev. Rul. 91-31; DODGE ET AL., *supra* note 4, at 176. Indeed, symmetry is today accepted as the sole rationale for debt discharge. *See* DODGE ET AL., *supra* note 4, at 136.

86. *See* Preslar v. Commissioner, 167 F.3d 1323, 1336 (10th Cir. 1999) (Ebel, J., dissenting) ("[T]he only way *Tufts'* holding 'underscores' the majority's holding is if a nonrecourse loan is treated as the functional equivalent of an unenforceable debt."). Judge Ebel stated that, though a taxpayer has no personal liability on a nonrecourse mortgage, the taxpayer still has liability to the extent of the underlying security interest. He then contended that, since there is some liability involved with a nonrecourse mortgage, *Tufts* is constrained to a nonrecourse mortgage and cannot be extended to a completely unenforceable debt. *See id.* at 1336–37.

87. *Tufts*, 461 U.S. at 307.

with the Court's rather explicit dicta,[88] strongly suggests that the Court has adopted the symmetry rationale without qualification.[89]

B. Debt-Discharge Income Reasoning and Its Effect on the Disputed-Debt Exception

1. Application of the disputed-debt exception under the freed assets rationale

If freeing assets is the test for whether a discharged debt is included in gross income, courts should interpret the disputed-debt exception more broadly by extending the exception to situations where the parties dispute the enforceability, as well as the amount, of a debt. The exception should extend this far because such a dispute centers around that which would make the discharged debt income: if the debt is truly unenforceable, the debt-discharge frees no assets and no gross income results. The taxpayer would not have to include this discharge because the debt never encumbered any assets. So, if a creditor were to forgive a loan, the taxpayer would not have to include the discharged amount in income if he could argue that the loan was unenforceable.[90]

2. Application of the disputed-debt exception under the symmetry rationale

Under symmetry, a court is concerned with how much benefit the debtor originally received (the front end of the loan) rather than how much the debt is actually worth to the debtor.[91] This theory is an administrative one; the only reason to allow the dispute to affect

88. *See supra* text accompanying notes 70-72.

89. Indeed, most today regard symmetry as the sole justification for the concept of debt-discharge income. *See* DODGE ET AL., *supra* note 4, at 136.

90. *See supra* Part II.B. Just how clear unenforceability must be may depend on the situation. As noted above, the Court found that where there was economic incentive to repay the debt was "enforceable" enough that its discharge would free assets. Exactly how far the Court would be willing to extend this "virtual" enforceability (i.e., moral incentive, social incentive, etc.) is unclear. What is important, though, is that under the "free assets" rationale the Court would, at some point, allow a question about unenforceability (completely apart from amount) to render debt discharge non-includable.

91. *See* Giangiordano, *supra* note 22, at 1201; Shaviro, *supra* note 11, at 242–43; *supra* Part II.B.

whether the discharge is included in gross income is because, where the parties themselves are unsure of the amount, the IRS also must be "unaware of the exact consideration initially exchanged in a transaction."[92]

At first glance, it may seem that symmetry is merely doing the same thing that the freed assets rationale does. By allowing a taxpayer to not include a debt-discharge because the parties to the transaction dispute the debt, the court is allowing them to determine, after the fact, what the debt is worth (or, in other words, what assets are really being freed). However, symmetry is different because it focuses on error-correction. The IRS taxes according to the parties' settlement, not because it cares what the parties think the debt is really worth (the assets they think it truly freed), but because the settlement is the only proxy the IRS has to determine how much the IRS had initially allowed the debtor to exclude from income.

An error-correction focus precludes the IRS from allowing deductions for disputes over enforceability. They do not care if the debt is enforceable because that does not affect the amount initially received and excluded. Likewise, the IRS does not really care that the parties do not agree on the original amount of debt. This figure, again, goes only to determining how much of the taxpayer's asset base the debt discharge freed.

Discharged debt, however, requires the IRS to take notice of the amount. If the service does not know how much the taxpayer initially excluded from gross income, it cannot levy a correct tax (in the same sense that the service, under the freed assets approach, could not equitably assess tax if the debt were not conclusively enforceable). In this case, the IRS has made a distinct choice; it has chosen to not get involved in the determination of the initial amount of the debt. Instead, it allows the parties to decide for themselves (through settlement or court process). The IRS essentially forgoes the tax revenue because, administratively, the effort to determine the amount of discharged debt would exceed the benefit.[93]

C. *The Difference Between* Preslar *and* Zarin

In *Preslar*, the Tenth Circuit recognized a distinct circuit split over the treatment of liquidated debts for the purpose of the dis-

92. *Preslar*, 167 F.3d at 1328.

93. *See* Zarin v. Commissioner, 916 F.2d 110, 115–16 (3d Cir. 1990).

puted-debt exception when it stated that "[t]he problem with the Third Circuit's holding is it treats liquidated and unliquidated debts alike."[94] The Third Circuit held that a debt certain as to amount and questionable only as to legal enforceability, when settled, was excluded from gross income by the debt-discharge exception.[95] The Tenth Circuit explicitly required a debt to be unliquidated before the exception can apply.[96]

At first glance, it may seem that *Zarin* differs from *Preslar* in only a semantic way. After all, the Third Circuit, instead of explicitly holding that a taxpayer can invoke the disputed debt exception and exclude debt-discharge when the debt is disputed only as to amount, stated that "[w]hen a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute."[97] Seemingly, the court only said that the term "enforceability" necessarily connotes "amount." Similarly, the reasoning and the split may appear based on the timing of valuation of consumption. The Third Circuit, by allowing a liquidated debt to qualify under the exception, seemed to allow parties to decide what the value of consumption "really" was at the time of purchase.[98]

Neither of these rationales explains the true difference between *Zarin* and *Preslar*.[99] To understand what the *Zarin* court was actually doing and where the split truly comes from, one must go deeper into the case. What *Zarin* did was look at the disputed-debt exception in light of the freed assets rationale. The court allowed the after-

94. *Preslar*, 167 F.3d at 1328.

95. *See Zarin*, 916 F.2d at 116.

96. *See Preslar*, 167 F.3d at 1328.

97. *Zarin*, 916 F.2d at 116.

98. *See* Shaviro, *supra* note 11, at 223–39. This ex post facto valuation is a corrupt method of valuing consumption. Shaviro points out that, under our current system, we assign a cost basis to consumption. A person is taxed on his consumption based on how much he paid for it, not his real psychic value. This reason, though perhaps not ideologically pure, is the acknowledged mode of performance for a number of reasons.

99. The court, somewhat disingenuously, made a couple of stabs at the proposition that all it was really doing was holding that enforceability connotes amount. For example, the court stated that "[i]f indeed the only issue was the enforceability of the entire debt, there would have been no settlement. Zarin would have owed all or nothing." *Zarin*, 916 F.2d at 116. This concept plainly ignores, though, the fact that a purely rational person, realizing that the debt was unenforceable, would refuse to pay the amount he originally had agreed to (assuming he originally assumed the debt enforceable). Even if he agreed as to the amount initially acquired, he would rationally push his advantage and drive a bargain for less than the initial amount. *See* Shaviro, *supra*, note 11, at 256.

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. This is what *Sobel* (a case the Third Circuit heavily relied on) did; it asked how much the original debt "really" was.[100] The Third Circuit, shadowing this reasoning, 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 counter-intuitive;[101] the court refused to stop at the standard cost-based approach. It allowed the parties to assign a value after they had concluded that the debt was legally unenforceable. If the court had used the symmetry approach it would not have concerned itself with the actual value to the taxpayer; it would have coldly asked how much the parties initially excluded—that is the amount that had to be included in gross income.[102]

That the court relied on the freed assets approach becomes still more apparent when one looks at the reasoning of the court. The Third Circuit drew primarily from *Sobel*. That case, decided before *Tufts*, relied on the freed assets justification when it analyzed whether the debt there in question qualified under the disputed-debt exception.[103] Indeed, the Third Circuit actually quoted freed assets language from *Sobel*.[104] Additionally, the court cited a Tenth Circuit case, *United States v. Hall*, which the court construed as supporting

100. *See* N. Sobel, Inc. v. Commissioner, 40 B.T.A. 1263 (1939).

101. *See* Zarin v. Commissioner, 92 T.C. 1084, 1101 (1989) (Tannenwald, J., dissenting).

102. Admittedly, here as well, the court could focus on the *value* of what was initially excluded rather than on the amount. However, it is much more detached for a court to cleanly ask how much cost-basis did the party originally receive when that question is the end of the analysis—that is all we are concerned with. Yet, when a court focuses on how much of the taxpayer's asset base the discharge freed (in essence equating current assets with the value of the debt), the court has difficulty acknowledging that the more one loses at a socially disapproved-of activity (like gambling), the more he should be taxed. *See Zarin*, 92 T.C. at 1101 (Tannenwald, J., dissenting) (decrying "the incongruous result that the more a gambler loses, the . . . larger the increase in his wealth"); Shaviro, *supra* note 11, at 235. If the Third Circuit, in *Zarin*, had focused on the cold reality of balancing off-setting amounts, raising taxes proportionally to a rising amount of gambling losses would not have troubled them. They certainly would not have been so troubled that they would abandon the standard ex ante cost valuation in favor of a subjective ex post facto valuation.

103. *See Zarin*, 40 B.T.A. 1263.

104. *See Zarin*, 916 F.2d at 115 ("[T]he Board held that the portion of the note forgiven by the bank 'was not the occasion for a freeing of assets and that there was no gain . . . .'" (quoting *Zarin*, 40 B.T.A. at 1265)).

the freed assets rationale.[105] In *Hall*, the Tenth Circuit ruled on a gambling case "factually similar to [*Zarin*]."[106] There, the Tenth Circuit seemed to hold "that because the debt was unenforceable, the amount of the loss and resulting debt cognizable for tax purposes were fixed by the settlement . . . ."[107] Again, the court looked at authority that applied the disputed-debt exception to a situation where debt-discharge income was based upon the freed assets approach.

So, the Third Circuit looked at these two freed assets cases and then allowed a debt, disputed only as to enforceability, to qualify under the disputed-debt exception. However, rather than explicitly stating that they were allowing taxpayers to except liquidated debts, the court rejected the Commissioner's arguments and authorities and, with no prior authority, stated that the question of amount is necessarily involved in the question of enforceability.[108] The only explanation for this is that the court had 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.[109]

Preslar, on the other hand, cleanly applied the symmetry justification to the debt-discharge exception and, as such, held that the disputed-debt exception applies only when the amount of the debt is unliquidated.[110] In essence, the court found that the "whole theory

105. *See Zarin*, 916 F.2d at 115–16.

106. *Id.* at 115.

107. *Id.* It should not surprise the reader to know that the Tenth Circuit, in *Preslar*, explicitly questioned the *Zarin* court's reliance on *Hall*. In addition to questioning *Hall*'s "continued viability . . . in light of. . . *Tufts*," the court argued that the taxpayer in *Hall* qualified for the disputed-debt exception because the debt was unliquidated, not because the debt was unenforceable. *Preslar*, 167 F.3d at 1329.

108. *See Zarin*, 916 F.2d at 116.

109. Again, the reason that the freed assets justification influenced the court is not that it forced the court to allow the parties to go back and assign a "real" value to the actual amount of consumption; one could just as easily argue that under the symmetry justification, a court should be interested in error-correction only as to the "real" value that was first received. If one starts, though, by realizing: (1) that *Zarin* stated that unenforceability *always* means that the amount of the debt is questionable and (2) that this proposition is clearly not true, one must ask himself why *Zarin* makes this leap. That the court focused on the freed assets justification explains this behavior. Since this 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.

110. *See Preslar*, 167 F.3d at 1328–29.

behind requiring that the amount of a debt be disputed before the contested liability exception can be triggered is that only in . . . [this context is] the . . . [IRS] unaware of the exact consideration initially exchanged in a transaction."[111] For this blunt proposition, the court relied wholly on only one law review article.[112] The proposition, though, was "underscored by the Supreme Court's holding in Tufts."[113] Having adopted the symmetry justification, the court directly disallowed the disputed-debt exception to apply to the *Preslar* debt because it was disputed only as to enforceability.

The circuit split really comes down to what justification the court is using. The Third Circuit focused on the freed assets approach (going through some questionable legal and semantic gymnastics to allow an unenforceable debt to qualify). The Tenth Circuit, on the other hand, concentrated on the symmetry justification; as such, any debt with a liquidated amount cannot qualify for the disputed-debt exception. So, deciding which circuit is right means deciding which justification is right.

D. Symmetry—The Correct Rationale

The *Preslar* court was right because it used the correct justification for the debt-discharge concept. Though the judicial concept of debt-discharge income started with the explicit justification of freed assets[114] and never really expressly moved to the justification of symmetry,[115] this reasoning better comports with the modern judicial concept of the broader definition of gross income.[116] It also just makes better sense.

Recall that the modern conceptualization of gross income arises primarily from the Supreme Court's reasoning in *Glenshaw*.[117] The Court held that Congress, in creating the federal income tax, in-

111. *Id.* at 1328.

112. *See* Shaviro, *supra* note 11.

113. *Preslar*, 167 F.3d at 1329.

114. It is true that Congress later codified the disputed-debt exception at 26 U.S.C § 61(a)(12) (1994), but this codification did not include a rationale. Presumably, Congress was satisfied enough with the Supreme Court's argument in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931) that it did not change the reasoning when creating the law.

115. *See* Commissioner v. Tufts, 461 U.S. 300, 300 n.11 (1983).

116. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

117. *See supra* Part II.

tended to paint an extremely wide stroke.[118] Basically, taxpayers must include in gross income everything they receive unless a specific provision of the I.R.C. explicitly allows a deduction.[119]

Symmetry comports with *Glenshaw* better than freed assets does because, by taking into account all debt proceeds originally received and not initially included in gross income, it reaches more of a taxpayer's consumption. Freed assets, on the other hand, excepts any unenforceable debt, and "[section] 61(a) of the Code, which taxes all accessions to wealth 'from whatever source derived,' clearly does not sanction such a result."[120] The freed assets approach is, in reality, a deduction—a deduction not explicitly laid out in the I.R.C. In addition to this, the plain fact that symmetry pulls more money into the tax base shows that it is more in line with *Glenshaw*.[121] Symmetry's broad grasp of everything capable of reasonable ascertainment fits in with this better than does the self-limiting reach of the freed assets approach.

Glenshaw also supports symmetry in a more implicit way. *Glenshaw* overruled an earlier definition of income that based gross income inclusion on the source of the income.[122] This earlier decision, *Eisner v. Macomber*, stated that "'[i]ncome may be defined as . . . derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets."[123] It is clear that *Glenshaw* destroyed this source-based treatment.[124] The freed assets approach is reminiscent of this kind of treatment because it asks the source of the income—that is, does it come from a specific type of loan (one that encumbers a person's assets). Symmetry, by ignoring the source altogether and only asking the amount of the debt (from whatever source), is much more in alignment with *Glenshaw*'s implicit overruling of the source-based definition of gross income of *Eisner*.

118. *See Glenshaw*, 348 U.S. at 426.

119. *See* DODGE ET AL., *supra* note 4, at 41.

120. Giangiordano, *supra* note 22, at 1200 (quoting 26 U.S.C § 61(a)(12)). The article also relies on the *Glenshaw* case for this proposition.

121. *See Glenshaw*, 348 U.S. at 429 ("[The I.R.C.] was used by Congress to exert . . . 'the full measure of its taxing power.'" (quoting Helvering v. Clifford, 309 U.S. 331, 334 (1940))).

122. *See* DODGE ET AL., *supra* note 4, at 62.

123. 252 U.S. 189, 207 (1920) (quoting Stratton's Independence v. Howbert, 231 U.S. 399, 415 (1913); Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185 (6th Cir. 1918)).

124. *See* DODGE ET AL., *supra* note 4, at 62.

Preslar's symmetry reasoning logically flows from *Glenshaw*. The *Glenshaw* court found that Congress intended to "tax all gains except those specifically exempted."[125] The freed assets approach artificially carves out an exemption. The symmetry rationale, in contrast, applies the exception only when it is truly necessary[126]—only when the IRS does not know the actual amount of the debt. That is, the service wants to tax everything possible, but the only reason they do not is because they do not know the actual amount initially excluded from gross income (not because of a contrived reason like not knowing how much of the taxpayer's assets were actually encumbered by the debt).[127]

Another indication that the symmetry approach has been adopted is Congress's treatment of the freed assets approach. Under the earlier approach, debtors did not recognize income if they were insolvent.[128] This resulted in the fact that a debtor, being obligated to include debt-discharge income only to the extent of freed assets, was immune from recognizing income if he was insolvent. On the other hand, if he were only minimally solvent, he had to recognize income only to the extent that assets exceeded liabilities (since you can only free assets that you have).[129] This rationale, however, "must have been regarded as flawed by Congress, for Congress preempted the common-law rule by enacting § 108(b), which provides that the insolvent debtor is . . . taxed on the debt-discharge income."[130] That Congress felt the freed assets approach so flawed as to need legislative rectification militates in favor of enforcing a different regime—symmetry.

Symmetry is also better in the sense that it treats all taxpayers the same. The freed assets approach allows one taxpayer, fortunate enough to incur unenforceable debt, to enjoy consumption tax free

125. *Glenshaw*, 348 U.S. at 430.

126. Granted, the judiciary can carve out exceptions to laws when it deems it necessary for a proper construction of the law. However, when choosing between two possible rationales for an exception, it makes sense to choose that which complies with other, previous constructions of the underlying law.

127. *See* Giangiordano, *supra* note 22, at 1200; Shaviro, *supra* note 11, at 256. The Tenth Circuit actually relied primarily on the *Shaviro* article for this proposition; however, even though there was no previous explicit authority, it is a well-reasoned and persuasive approach to prior statutory and case law.

128. *See* DODGE ET AL., *supra* note 4, at 136.

129. *See id.* at 135–36.

130. *Id.* at 136.

(or partially tax-free), where another taxpayer will have to pay for the identical consumption in after-tax dollars.[131] This is yet another way that the freed assets approach is incompatible with how Congress has chosen to tax us and how the Supreme Court has chosen to interpret tax law. Income tax laws should be interpreted broadly, giving exceptions only where they have been explicitly carved out.

E. The Right Rule the Wrong Way

The Tenth Circuit adopted the right justification for disputed-debt income. It decided to look at the debt and hold that, if it were liquidated (enforceable or not), the Preslars would have to include any debt-discharge amount in gross income. The court, however, incorrectly ruled that the Preslars' debt was liquidated.

Under the Preslars' original debt arrangement, Moncor Bank allowed them to repay their loan by assigning sales contracts to the bank at a discount rate.[132] Later, when the FDIC became receiver for the bank, the FDIC refused to allow that method of payment on the note.[133] The Preslars claimed, and the Tax Court agreed, that the original amount of debt had been inflated and that they had accepted this inflated amount only because the bank had agreed to the unique arrangement of repayment.[134]

In other words, the Preslars claimed that the debt was unliquidated because there was a dispute over the method of repayment. The Tenth Circuit disagreed. The court stated that the Preslars had presented no "competent evidence to support their theory that their loan obligation was linked to the repayment scheme"[135] and that "the Preslars' underlying indebtedness remained liquidated at all times."[136]

This logic seems clear at first glance—the way a debt is paid does not affect the actual amount of the debt. This decision, though, ignores a number of economic realities. A debt can be unliquidated, even though the parties agree on the original amount, because the method of repayment can affect how much the debt is actually

131. *See* Giangiordano, *supra* note 22, at 1201.
132. *See* Preslar v. Commissioner, 167 F.3d 1323, 1325 (10th Cir. 1999).
133. *See id.*
134. *See id.* at 1329.
135. *Id.* at 1330.
136. *Id.*

worth. Many different aspects of the method of repayment could affect the actual cash value of the debt. That the bank willingly assumed the contracts meant that they lost the time value of money; the Preslars received credit for the payment *now*, whereas the bank did not receive the cash for an extended period of time.[137] Also, the assumption of the contracts meant that the bank assumed the risk and hassle of collecting on them—another factor that would decrease the value of the actual assignment.

This meant that, though the parties attached a certain amount to the initial note, the value of the debt initially received, and not included in gross income, actually depended on the method of repayment.[138] This is not a startling idea, and, indeed, the Tenth Circuit seemed to agree that this was possible when it stated that "[i]t is conceivable that two parties could negotiate a loan transaction in which the underlying amount of a debt is tied to the existence or nonexistence of some post-execution event."[139] The court erred on the side of caution and adopted too narrow a view of when a debt is liquidated. The court should have taken into account the repayment methods of which the parties initially conceived, methods that affect how much the Preslars originally excluded from their gross income.[140]

The court's other problem, that of evidence, is wholly misplaced. The court went out of its way and overturned the lower court's find-

137. Time value of money is an extraordinarily important aspect of finance. It is, in essence, what interest is all about: people pay interest for the right to use another's money. Depending on a number of factors, the fact that the bank assumed the Preslars' contracts for future money and credited their loan amount presently could have been worth hundreds of thousands of dollars to the Preslars.

138. Though this seems similar to the ex post facto valuation that *Zarin* incorrectly condoned, it differs with regards to timing. The taxpayer is not going back, after the fact, and claiming that the value of a sum-certain debt was actually less than what he actually agreed to repay. Here, the taxpayer is claiming that the agreement *initially* included terms that *initially* made the debt worth less. This means that the parties are actually disagreeing as to the *initial* amount of the loan.

139. *Preslar*, 167 F.3d at 1329–30. Possibly, what the Tenth Circuit meant by this was that the amount of a loan could be tied to a subsequent event when the exact amount of the original debt is not expressly specified. For example, John owes one-half of what his mother leaves him upon her death (his mother is still alive). However, these words are also susceptible to the interpretation that the value of the amount of the debt, though the amount is specifically set, can vary according to how the method of repayment plays out (i.e., how successful the Preslars are in selling contracts to assign to the bank).

140. This makes sense if one supposes that the Preslars would not have agreed initially to assume one million dollars of debt had not the special method of repayment existed.

ing as to the evidence.[141] Though it adopted the correct mode of analysis, it fed that analysis with incorrect facts by disallowing the lower court's findings in favor of its own. As the dissent correctly pointed out, "the majority overlook[ed] significant evidence in the record as well as the high standard of clear error for overturning the [lower court's] factual finding."[142] The Tenth Circuit should have found that the method of payment can affect the amount of the debt; that, as such, a dispute as to method can be a dispute as to amount; and that, following the Tax Court's factual findings, the Preslars had a legitimate dispute as to method and, hence, amount.

V. CONCLUSION

In conclusion, the *Preslar* court correctly disagreed with the Third Circuit's holding in *Zarin* and held that the disputed-debt exception applies only to debts with unliquidated amounts. The court did so because it recognized that the rationale for debt-discharge income has changed since its first inception. Because this rationale has changed from freed assets to symmetry, a debt-discharge should not be excluded from gross income when it is disputed only as to enforceability. The only reason to exclude is that the parties dispute the *amount* of the debt and it cannot be known for certain; hence, the IRS does not know how much was initially excluded from gross income.[143]

However, having adopted the correct rationale and exception construction, the court promptly misapplied it. The court incorrectly held that the method of repayment did not affect the initial amount of the loan and that, even if it did, there was no evidence in this case that their loan was linked to a unique repayment method. The court should have recognized that the method of repayment can indeed affect the initial value of a loan. The court also should have respected the lower court's finding that, in this case, the parties did indeed dis-

141. *See Preslar*, 167 F.3d at 1330.

142. *Id.* at 1334 (Ebel, J., dissenting) (relying on 26 U.S.C. § 7482(a)(1) (1994) and Exxon Corp. v. Gann, 21 F.3d 1002 (10th Cir. 1994)).

143. This conclusion should not be over-emphasized to completely crowd out the significance of unenforceability. It is clearly conceivable that the unenforceability of a debt could cast legitimate doubt on the true amount of the debt. If the unenforceability of the debt makes a court believe that the parties never really agreed on a set amount, the disputed debt exception should apply. The point of this Note is that when the parties dispute only the enforceability, the amount being completely clear, the disputed debt exception should not apply.

agree, in good faith, over the method. In sum, the court incorrectly applied the correct doctrine and came to an incorrect conclusion.

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