

Cancellation of Indebtedness as Income under Pennsylvania Law, Part IV.

To round out the discussion of *Marshall v. Commonwealth*, No. 933 F.R. 2008 (Pa. Commw. Jan. 3, 2012), I first want to address another major argument that Mr. Marshall made in Commonwealth Court, which involved the tax benefit rule.

The tax benefit rule is a federal common law rule that was developed to address anomalies that arise out of timing in a tax system that requires annual accounting. A common example used to illustrate the rule is to assume that a taxpayer has an outstanding loan to a debtor, whose financial situation deteriorates to the point that the loan appeared to be uncollectible as the end of year 1. As a consequence, the taxpayer takes a deduction for the loss associated with the bad debt. If the debtor's situation turns around in the next year and the loan is repaid, the taxpayer would then report as income the interest, which would normally be income, *and* the principal repayment, which normally would be treated as non-taxable return of capital. *See Hillsborough Nat'l Bank v. Comm'r*, 460 U.S. 370, 377-79 (1983). The payment of principal is treated as income because of the loss that was previously deducted, and the tax benefit rule serves to balance out the deduction with recognition of income in an equal amount. What if the deduction had little or no impact on the taxpayer's tax liability in year 1? The Internal Revenue Code addresses this in Section 111(a); the taxpayer is only required to include the payments received in year 2 to the extent that the related deduction had an impact on his tax liability.

Mr. Marshall sought to invoke this principle to reduce the amount realized upon disposition when the lender foreclosed upon the partnership's property; he argued that any gain recognized by the partnership on the accrued but unpaid interest under the note should be limited, as the partnership had only benefited from a deduction associated with the accrued but unpaid interest to a limited extent. If the argument had succeeded, the amount realized based upon the interest component of the debt would have dropped from over two billion dollars to \$121,600,000. *Marshall*, slip op. at 31.

Marshall's tax benefit argument was a creative one, but was nonetheless rejected by the majority. The argument has some problems: first, since he was asking the court to apply a federal tax principle to reduce his state tax liability, Marshall's position was undercut by the fact that the record indicated that for federal income tax purposes, the entire amount of the loan, interest and principal, were included in the amount realized. *Marshall*, slip op. at 31 n. 26. Second, the Supreme Court, in *Tufts*, indicated that its holding requiring the entire amount of a non-recourse loan to be included in the amount realized did not rest upon the tax benefit rule. Third, as the majority noted, Pennsylvania does not permit a taxpayer to offset a gain or loss in one class of income against another, which precluded the use of operating losses to offset gains associated with disposition of property. *Marshall*, slip op. at 35-36. The majority also noted that Mr. Marshall was essentially asking to use a net operating loss carryover where the legislature did not enact one. *Id.* at 36-37. The disposition of the tax benefit argument is probably one of the stronger parts of the majority opinion.

One issue that was not addressed by the majority is whether the continued advancement of interest until it rose to some 2.6 billion dollars really represented a true loan. The issue is touched upon briefly by the dissenters. It is relevant from a legal perspective because the *Tufts* Court indicated that a non-recourse loan could have been treated by the IRS as a joint venture and not a true loan. 461 U.S. at 308 n.5. While I have not done the type of comprehensive

research I would want to do if briefing the issue, I found one reported case where the Seventh Circuit concluded that the prospect for repayment of a loan was sufficiently speculative that it should not be treated as a true loan. *Saviano v. Comm’r*, 765 F.2d 643, 649-50 (7th Cir. 1985). It would be interesting to have seen this issue developed more fully; the facts suggest that at the outset this was meant to be a true loan, but over the twenty years that the partnership operated at a loss and the lender continued to defer payments did the relationship become a joint venture?

Mr. Marshall’s case is currently before the Commonwealth Court on exceptions. If those are unsuccessful, I hope that he pursues review in the Supreme Court, as I think he has some solid arguments to make, particularly under the uniformity clause and the scope of the relevant provision of the personal income tax.

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