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Inside *Zarin*

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THE basic facts appear in almost every introductory tax law casebook. During the first four months of 1980, David Zarin, a widely respected real estate developer who had contributed significantly to the development of Atlantic City, lost control of his gambling.[1] At the height of his compulsion, he played craps twelve to sixteen hours a day, seven days a week, betting as much as $15,000 on each roll of the dice.[2] During that four-month period alone, he probably placed over $125 million in bets.[3] A New Jersey regulator called him "the biggest casino credit player here or in Nevada."[4] The casino, Resorts International ("Resorts"), rewarded him with a luxury three-room suite, meals, entertainment, and twenty-four-hour access to a limousine.[5]

Then his bank refused to honor his checks—$3,435,000 worth.[6] The casino sued;[7] he countersued.[8] A year later, the parties settled. Zarin agreed to pay Resorts $500,000; the casino dropped its remaining claims. Over a two-year period Zarin had lost almost $6 million to gambling; the settlement reduced his out-of-pocket losses to a mere $3 million.[9] He was insolvent[10] but sober. He joined Gamblers Anonymous and became Chair of the Advisory Board to the National Foundation for the Study of Pathological Gambling.[11] He never gambled again.[12]

Some would view Zarin's story as a precautionary tale on the perils of compulsive gambling.[13] The Internal Revenue Service ("IRS") saw instead a $2,935,000 taxable debt discharge.[14] At a seventy percent rate,

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1. *See* Stipulation of Facts at 11, Zarin v. Commissioner, 92 T.C. 1084 (1989) (No. 21371-86) (1989) [hereinafter Stipulation].
2. *Id.*
3. *See infra* note 45.
4. *See* Daniel Heneghan, *Resorts Fined for Credit*, ATLANTIC CITY PRESS, July 7, 1983, at 22 (statement attributed to New Jersey Casino Control Commissioner Carl Zeitz).
5. Stipulation, *supra* note 1, at 5.
6. *Id.* at 12.
7. *See* Zarin v. Comm'r, 916 F.2d 110, 112 (3d Cir. 1990) (discussing the 1980 claim against Zarin).
8. *Id.*
9. Stipulation, *supra* note 1, at 14.
10. *See infra* notes 77-78 and accompanying text.
11. Stipulation, *supra* note 1, at 15.
12. *Id.*
13. *Id.*
14. *Id.*

this implied a federal income tax liability of over $2 million.[15] By the time the issue reached the courts almost a decade later, the IRS claimed some $5.2 million in back taxes and interest.[16] Zarin lost in the Tax Court, eleven to eight.[17] He won in the Third Circuit, two to one.[18] After ten long years, at age seventy-two, he was free.[19]

To his great distress, David Zarin has become the most famous gambler in United States tax history. Yet one might wonder why the tax case that bears his name has been so widely read and analyzed. After all, its fact pattern is unlikely to be repeated. Its direct precedential value, therefore, is minimal.[20]

The answer lies in the often misunderstood nature of law. A simple model of statutory law, common among students, reads something like this: Congress enacts rules. Courts find facts and apply the rules to the facts or, at most, fill gaps in existing rules. All a student need do is to memorize the rules (or, if the exam is open book, know where to look them up) and discuss their application in the classic "on-the-one-hand, on-the-other-hand" tradition.

But law is not simply the application of rules to facts. Its goals are more profound; its means more subtle. Ultimately, law uses words, ideas, and processes to limit the exercise of power, implement norms, and create some degree of social order, legitimacy, and perceived equality. A "rule" is merely a requirement that similar situations be treated similarly; its function is to constrain.[21] But reality is infinitely complex, and our moral and political judgments richly nuanced. To be workable, therefore, law must simplify. To this end, our legal system reduces bewildering reality to a few manageable "material facts" and complex moral and political conclusions to rote phrases. Ultimately, courts do apply rules to facts, but this is merely one step in a much more complicated process.

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15. *Id.*

16. *See* Zarin v. Comm'r, 916 F.2d 110, 112 (3d Cir. 1990) (noting that the total tax bill to April 5, 1990, reached $5,209,033.96).

17. Zarin v. Comm'r, 92 T.C. 1084, 1085 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990).

18. *Zarin*, 916 F.2d at 117.

19. *See id.*

20. The Tax Court does not appear to have accepted any of the Third Circuit's conclusions in *Zarin*. *See generally, e.g.*, Rood v. Comm'r, 71 T.C.M. (CCH) 3125 n.1 (1996) (addressing whether the disputed debt rule applies only to an unliquidated debt, as held by the *Zarin* Tax Court majority, or also to a debt the enforceability of which is disputed, as held by the Third Circuit, an issue that still remains open); Collins v. Comm'r, 64 T.C.M. (CCH) 557 n.9 (1992), *aff'd*, 3 F.3d 625 (2d Cir. 1993) (finding that it was not bound by Third Circuit's conclusion that casino chips have no value); Schlifke v. Comm'r, 61 T.C.M. (CCH) 1697, 1698 (1991) (stating that

> we find it unnecessary to cut our way through the thicket of sub-issues which inhere in [the *Zarin*] controversy, such as the presence of a liquidated, as distinguished from an unliquidated, indebtedness, and the enforceability of the underlying obligation, i.e., whether it is void or voidable and the impact of the element of rescission thereon.).

21. Perhaps for this reason, rule making and rule application are normally allocated to different bodies. *See, e.g.*, THE FEDERALIST NO. 78, at 504, 510 (Alexander Hamilton) (Edward Mead Earle ed., 1937). A rulemaking body normally has the power to change rules and is therefore less constrained by existing rules.

One might expect a legal system based on sometimes cartoonish simplification to be unsatisfactory. Legitimacy requires more than mere consistency; it also requires some adherence to intuitive notions of right and wrong. Nevertheless, in the run-of-the-mill case our system works surprisingly well. It breaks down primarily in cases for which the articulated rules were not designed. By studying how and when the system breaks down, we can better understand how it works—or, indeed, perhaps even how to make it work better. For this reason, law school texts often include atypical cases, cases in which the articulated rules do not quite work. Legal scholarship focuses disproportionately on such cases as well.

Zarin v. Commissioner is one such case.[22] Much has been written about *Zarin*,[23] which has become one of the most widely-used teaching cases in tax law.[24] To date, however, published analyses appear to have

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22. *See generally Zarin*, 92 T.C. 1084.

23. *See generally, e.g.*, Babette B. Barton, *Legal and Tax Incidents of Compulsive Behavior: Lessons from Zarin*, 45 TAX LAW. 749 (1992); Richard C.E. Beck, *Cancellation of Debt and Other Incidental Items of Income: Puritan Tax Rules in the U.S.*, 49 N.Y.L. SCH. L. REV. 695 (2004); William R. Culp, Jr. & Richard E. Marsh, Jr., *Avoiding Cancellation of Debt Income Where the Liability Is Disputed*, 74 J. TAX'N 288 (1991); Joseph M. Dodge, Zarin v. Commissioner*: Musings About Debt Cancellations and "Consumption" in an Income Tax Base*, 45 TAX L. REV. 677 (1990); Kurt H. Eberle, *Challenges to Enforceability of a Debt Do Not Trigger the Contested Liability Exception to the Discharge-of-Indebtedness Income Rule:* Preslar v. Commissioner, 53 TAX LAW. 535, 536 (2000); Gregory M. Giangiordano, *Taxation—Discharge of Indebtedness Income—*Zarin v. Commissioner, 64 TEMP. L. REV. 1189 (1991); Stephen D.D. Hamilton, *Third Circuit's Contingent Liability Theory Produces Correct Result in Gambling Debt Discharge Case*, 50 TAX NOTES 409 (1991); Calvin H. Johnson, Zarin *and the Tax Benefit Rule: Tax Models for Gambling Losses and the Forgiveness of Gambling Debts*, 45 TAX L. REV. 697 (1990); I. Jay Katz, *Did Zarin Have a Tufts Day at a Casino Made out of Kirby Lumber?*, 26 U.C. DAVIS L. REV. 261 (1993); Douglas E. Kulper, Note, *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 (1991); James L. Musselman, *Is Income from Discharge of Indebtedness Really Income at All? A Proposal for a More Reasoned Analysis*, 34 U. MEM. L. REV. 607, 616 (2004); Robert G. Nassau, *Cancellation of Gambling Debts and Not-So-Phantom Income*, 50 TAX NOTES 188 (1991); Joel S. Newman, *Five Will Get You Ten: You Haven't Heard the Last About Zarin*, 50 TAX NOTES 667, 668 (1991); Chad J. Pomeroy, Preslar v. Commissioner*: Debt Discharge Income and Its Rationale*, 2000 B.Y.U. L. REV. 1677, 1685 (2000); Jon D. Rigney, Note, Zarin v. Commissioner, *The Continuing Validity of Case Law Exceptions to Discharge of Indebtedness Income*, 28 SAN DIEGO L. REV. 981 (1991); Daniel N. Shaviro, *Psychic Income Revisited: Response to Professors Johnson and Dodge*, 45 TAX L. REV. 707 (1990); Daniel Shaviro, *The Man Who Lost Too Much:* Zarin v. Commissioner *and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215 (1990); Lee A. Sheppard, *A Gambling Exception to Cancellation of Indebtedness Income?*, 49 TAX NOTES 1516 (1990); Susan Clark Taylor, Comment, *Income Taxation—*Zarin v. Commissioner*: The Viability of the Transactional Approach to Discharge of Indebtedness Income*, 20 MEM. ST. U.L. REV. 235, 242 (1990); Stephen A. Zorn, *The Federal Income Tax Treatment of Gambling: Fairness or Obsolete Moralism?*, 49 TAX LAW. 1 (1995); Mark J. Marroni, Comment, Zarin v. Commissioner*: Does a Gambler Have Income from the Cancellation of a Casino Debt?*, 27 NEW ENG. L. REV. 993 (1993).

24. *Zarin* appears in almost every major introductory U.S. tax casebook. *See, e.g.*, J. MARTIN BURKE & MICHAEL K. FRIEL, TAXATION OF INDIVIDUAL INCOME 165-66 (7th ed. 2004); JOSEPH M. DODGE ET AL., FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY 312-20 (3d ed. 2004); JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION 166-75 (13th ed. 2004); MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 180-88 (5th ed. 2005); SANFORD M. GUERIN & PHILIP F. POSTLEWAITE, PROBLEMS AND MATERIALS IN FEDERAL INCOME

been based solely on the two published court opinions, which omit much that is relevant to an understanding of the case. I was principal author of the briefs filed on Zarin's behalf before the Third Circuit.[25] Since moving to law-teaching, I have remained puzzled about the problems the case presents.[26] This Article, therefore, is both a practitioner's and a theorist's account of *Zarin*, a story of the intersection of process, doctrine, and theory, a story of how law works—and how it sometimes fails.

I. WHAT HAPPENED: A PRACTITIONER'S ACCOUNT

A. How It Began

Some lawsuits are brought to implement policy decisions, some to resolve pre-existing political or business controversies, some as expressions of personal ill-will. *Zarin* arose almost by accident, a fact that affected how it was litigated and ultimately decided.

How did *Zarin* begin? More to the point, why did the IRS raise the debt discharge claim at all? Large numbers of gamblers default on their casino debts every year;[27] it is unlikely that any of them ever report their defaulted debt as income. The only prior case to consider the issue held that a discharge of gambling debt was not income.[28] Had Zarin lost, he might well have been the first taxpayer in American history to have paid federal income tax because of a discharge of gambling debt.[29] If one of

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Taxation 51-56 (6th ed. 2002); Alan Gunn & Larry D. Ward, Cases, Text and Problems on Federal Income Taxation 132-38 (5th ed. 2002); Douglas A. Kahn, Federal Income Tax 71-75 (3d ed. 1994); William A. Klein et al., Federal Income Taxation 150-59 (14th ed. 2006); Michael A. Livingston, Taxation: Law, Planning, & Policy 253-65 (2003); Laurie L. Malman et al., Problems, Cases and Materials on Federal Income Taxation 153-63 (2002); Joel S. Newman, Federal Income Taxation 50-59 (2002); Richard Schmalbeck & Lawrence Zelenak, Federal Income Taxation 240-49 (2004); Richard Westin, Basic Federal Income Taxation 67-75 (2002). *See also* Marvin A. Chirelstein, Federal Income Taxation 55-57 (10th ed. 2005).

25. Also contributing significantly to the briefs were William M. Goldstein, Harry L. Gutman, and Stephen D.D. Hamilton. Mr. Goldstein argued the case before the Third Circuit.

26. My exploration of the debt discharge doctrine as a whole appears in Theodore P. Seto, *The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System*, 51 Tax L. Rev. 199 (1996).

27. In 1981, Atlantic City casinos extended $1,045,070,361 in credit; comparable statistics are apparently not publicly available for Nevada casinos, although total gambling volume is higher in Nevada. *See* Vicki Abt et al., The Business of Risk: Commercial Gambling in Mainstream America 76 (1985). Several decisions have estimated that collections on such credit average roughly ninety-six percent. *See, e.g.*, Flamingo Resort, Inc. v. United States, 664 F.2d 1387, 1389 (9th Cir. 1982), *cert. denied*, 459 U.S. 1039 (1982); Desert Palace, Inc. v. Comm'r, 72 T.C. 1033, 1044 (1979), *rev'd on other grounds*, 698 F.2d 1229 (9th Cir. 1982), *cert. denied*, 464 U.S. 816 (1983); Rev. Rul. 83-106, 1983-2 C.B. 77. This would imply a 1981 casino debt default volume for Atlantic City of some $40 million, and for the United States as a whole in excess of $100 million.

28. *See* United States v. Hall, 307 F.2d 238, 242 (10th Cir. 1962).

29. Since *Zarin*, the IRS has once successfully contended that a discharge of enforceable casino gambling debt is taxable. *See* Rood v. Comm'r, 71 T.C.M. (CCH) 3125 (1996) (holding that a taxpayer failed to prove that casino gambling debt was disputed).

the goals of law is to treat equally situated people equally, the very bringing of the case might seem improper.

The answer is simple: *Zarin* did not begin as a debt discharge case. David Zarin was a well-known, widely-respected public figure in Atlantic City—a pioneering real estate developer responsible for much of the city's modern low-income and senior housing.[30] His troubles at Resorts quickly became newsworthy.[31] Resorts charged Zarin with intentionally writing bad checks—a fraudulent act.[32] Zarin was even criminally indicted.[33] Zarin, in turn, accused Resorts of Racketeer Influenced and Corrupt Organization ("RICO") violations.[34] The New Jersey gaming authorities filed a complaint against Resorts alleging violations of the casino credit laws,[35] a case that settled when Resorts conceded fault and agreed to be fined.[36]

In effect, Zarin was accused of having taken something without paying for it. Initially, therefore, the IRS sought merely to tax him on the proceeds of that alleged "theft." Its notice of deficiency asserted that he had realized taxable income in 1980—the year of the gambling fiasco, not the year of the settlement—"in the amount of $3,435,000 as a result of larceny by trick and deception."[37] Thus, *Zarin* was originally a 1980 income-by-theft case, not a 1981 discharge-of-indebtedness case.

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30. *See, e.g.*, Stipulation, *supra* note 1, at 3 (discussing that Zarin built 643 units for low-income families and the elderly in 1978 and 1979); WHO'S WHO IN THE EAST (22d ed. 1989) (recipient, Concern for People of Atlantic City Award, Atlantic City 1984; Citizen of Vision Award, N.J. Assembly 1985; Legion of Honor Award, Chapel of Four Chaplains 1985); Michael Checcio, *Zarin, Sailor Honored for A.C. Work*, ATLANTIC CITY PRESS, Nov. 7, 1987 (Greater Atlantic City Chamber of Commerce business man of the year); Joann S. Lublin, *Controversial Federal Program Helps Developer to Build Rental Units, Mainly for Middle Class*, WALL ST. J., Aug. 20, 1985 (stating that Zarin built the first private rental apartments in twenty years in Atlantic City's depressed Inlet section); Sonny Schwartz, *City Honors A.C.'s Housing Pioneer*, ATLANTIC CITY PRESS, Nov. 4, 1987 (discussing "the man who has pioneered Atlantic City's housing revitalization").

31. *See, e.g.*, *Casino Is Accused by Man it Had Sued*, N.Y. TIMES, Dec. 10, 1980, at B2; Richard Haitch, *Follow-Up on the News; High Rolling*, N.Y. TIMES, Mar. 21, 1982, at 41; *N.J. Man Sues Resorts Intl. for Letting Him Run up Debt*, WALL ST. J., Dec. 10, 1980, at 37; *Resorts, Developer Trade Suits over Dice Debts*, ATLANTIC CITY PRESS, Dec. 10, 1980; Brett Skakun, *Developer Charged with $4.3M. Casino Credit Fraud*, ATLANTIC CITY PRESS, May 8, 1981; Louis Toscano, *Resorts, Zarin Settle $3.5 M. Debt*, ATLANTIC CITY PRESS, Oct. 7, 1981.

32. *See* Complaint at 3, Resorts Int'l Hotel Casino, Inc. v. Zarin, No. L-14602-80 (N.J. Super. Ct. Atl. City Div. 1980).

33. *See* Skakun, *supra* note 31.

34. *See id.*; *Resorts, Developer Trade Suits over Dice Debts*, *supra* note 31. The Racketeer Influenced and Corrupt Organizations Act of 1970, 18 U.S.C. §§ 1961-1968 (1997), permits suits for treble damages plus attorneys' fees by any person injured by, among other things, a pattern of collection of unlawful debt. Unlawful debt, for this purpose, includes "a debt (A) incurred or contracted in gambling activity which was in violation of the law of . . . a State . . . and (B) which was incurred in connection with the business of gambling in violation of the law of . . a State . . . ." *Id.* § 1961(6).

35. Daniel Heneghan, *Resorts Contests Charges of Credit Violations*, ATLANTIC CITY PRESS, May 13, 1981; Toscano, *supra* note 31.

36. *See* Final Order, N.J. v. Resorts Int'l Hotel, Inc., N.J. Casino Control Commission Docket No. 81-19 (1983).

37. *See* Stipulation, *supra* note 1, at 4, Exhibit 3-C, Notice of Deficiency, David Zarin, Tax Years 1980 & 1981.

Zarin responded to all three adversaries—the district attorney, Resorts, and the IRS—by pointing out that at no time had he intended to defraud anyone. He had always paid his gambling debts before, more than $2.5 million worth.[38] During the heat of his gambling compulsion he had simply become unaware of their amount.[39] If anything, he was a victim, not a wrong-doer.

On the facts, Zarin appears to have had much the stronger case.[40] The criminal charges were dropped by the district attorney. Resorts settled for a small fraction of its claim. This left the only IRS, which now found itself in need of a new theory. If Zarin could prove that he had always intended to pay his debts but had simply become unaware of their amount, existing law required a judgment in his favor on the income-by-theft claim; such law appeared to hold that the $3,435,000 should be treated as debt to be repaid at some future date, not as income.[41]

As fate would have it, Zarin had other tax problems in both 1980 and 1981, arising primarily out of his real estate activities. These non-gambling issues remained unresolved when time came to take the asserted 1980 income-by-theft deficiency to court. As a result, Zarin's counsel made the unfortunate decision to combine both years in a single Tax Court petition. The non-gambling issues were ultimately settled; the consequence of the single petition, however, was to leave 1981 open and before the court. This allowed the IRS, on August 25, 1986, five years after the fact, to assert for the first time that Zarin had "realized income in the year 1981 in the amount of $2,935,000 through cancellation of indebtedness."[42]

There was a third argument—probably a winner—that the IRS could have made but did not. In 1980, as now, for regular tax purposes gam-

38. *See* Stipulation, *supra* note 1, at 3, 8 (stating that Zarin paid $50,000 of gambling debt in mid-1970s, $10,000 of gambling debt in late 1970s, $2,500,000 of gambling debt between June 1978 and December 1979).

39. *See id.* at 11.

40. In addition to Zarin's history of repayment of gambling debts, see *supra* note 38, Zarin's actions after the casino cut off his credit evidenced an intention to repay. The following day he requested an appointment with the CEO of Resorts "to work out the method for paying off [his] obligations." Stipulation, *supra* note 1, at 13. The following week, they met. "[T]he amount of the debt was not yet known but Zarin assured Davis that Resorts would be fully paid." *Id.* Zarin provided his personal and business financial statements to facilitate negotiation of a work-out schedule. *Id.* Zarin's answer to Resorts's state court complaint, denying liability for the asserted debts, was not filed until March 4, 1981. *See* Answer, Resorts Int'l Hotel Casino, Inc. v. Zarin, No. L-14602-80 (N.J. Super. Ct. Atl. City Div. 1980).

41. *See, e.g.*, James v. United States, 366 U.S. 213, 219 (1961) (finding that "[w]hen a taxpayer acquires earnings . . . without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition" he is required to report such earnings as income); Liddy v. Comm'r, 808 F.2d 312, 314 (4th Cir. 1986) (stating that "[o]nly if the taxpayer can show that he has no claim of right by reason of a requirement to make prompt payments of amounts received even if such payments are made in the absence of an enforceable obligation . . . is the receipt of monies not deemed gross income").

42. Answer at 2, Zarin v. Comm'r, 92 T.C. 1084 (1989) (No. 21371-86).

bling losses could be deducted to the extent of gambling winnings.[43] In other words, the regular income tax was imposed solely on a gambler's *net* winnings. For alternative minimum tax ("AMT") purposes, however, gross gambling winnings were includible in income but gambling losses were not deductible by recreational gamblers to the extent they exceeded sixty percent of a modified form of adjusted gross income ("AGI").[44] The AMT, in effect, was imposed in part on a recreational gambler's *gross* winnings. Based on the available evidence, an expert might have estimated Zarin's gross 1980 winnings to have been roughly $61.9 million.[45] Had the IRS chosen to make this argument, it could have claimed that Zarin owed roughly $6.2 million in back taxes for 1980, plus interest and penalties. On the law, it might well have won.

We can only speculate why the IRS failed to make the argument. There are hints in Zarin's protest to the IRS Appeals Division, filed before the case went to Tax Court, that it considered doing so.[46] The requisite IRS gambling statistical expert may not have been consulted. Or the IRS may have viewed the AMT rules, thus applied, as extreme

43. *See* I.R.C. § 165(d) (1980); Treas. Reg. §1.165-10 (1960).

44. I.R.C. § 55(a) imposed an AMT on alternative minimum taxable income, which was computed by adding back tax preference items for adjusted itemized deductions and capital gains. *See* I.R.C. § 55(b)(1). I.R.C. § 57(b)(1) defined "adjusted itemized deductions" as the amount by which itemized deductions other than those for state and local taxes, medical and dental expenses, personal casualty losses, and estate taxes ("nonpreference deductions") exceeded sixty percent of AGI reduced by nonpreference deductions. Zarin's gambling losses were itemized deductions to the extent that they exceeded sixty percent of AGI reduced by nonpreference deductions, therefore they constituted tax preference items subject to the AMT. Had Zarin been engaged in the trade or business of gambling, the losses would not have been itemized deductions at all, and therefore would not have been subject to the AMT. *See* Comm'r v. Groetzinger, 480 U.S. 23, 23 (1986). In 1982, the AMT rules were changed to eliminate wagering losses as a tax preference item. *See* I.R.C. §§ 55-56 (1982).

45. Particular bets at craps have house advantages ranging from 1.402% to 16.667%. In combined bets, the lowest house advantage in a single odds craps game is .8%; in a double odds game it is .6%. *See, e.g.*, Avery Cardoza, How to Win at Gambling 92 (1994); Edwin Silberstang, How to Gamble and Win 52 (1979). It has been estimated that the average house advantage in craps is 2.7%. *See* Abt et al., *supra* note 27, at 227-28. Given total net losses of $3,435,000, and assuming that Zarin faced average odds and had average luck, his total bets over the period can be computed to have been about $127,222,222, and his gross winnings about $61,893,611. [Total bets = net losses / house advantage. Gross winnings = (.5 - (house advantage / 2)) x net loss / house advantage.]

Interestingly, this computation suggests that Stipulation may have overstated the intensity of Zarin's gambling. It has been estimated that dice are rolled as often as 200 times an hour at a well-run craps table. *See* Tom Ainslie, How to Gamble in a Casino 83 (1979). Assuming that Zarin gambled for 119 days for an average of 14 hours per day and 120 rolls per hour, over the four-month period he would have made about 200,000 rolls. If he actually bet $15,000 per roll, his total bets over the period would have been about $3 billion, over twenty-three times the same figure computed on the basis of his net losses, assuming that he faced average odds. It is possible, of course, that he did not gamble every day, that he took off time for other activities even on days on which he did gamble, that the house maximum was often substantially lower than $15,000 per roll, and that he bet less than the house maximum on most rolls. On the other hand, it is also possible that he, on average, accepted worse than average odds.

46. *See* Protest at 33-37, Exhibit A, *In re* David Zarin Taxable Years 1980 & 1981, Respondent's Objection to Petitioner's Request for Reconsideration, Zarin v. Comm'r, 92 T.C. 1084 (1989) (No. 21371-86).

and worried that courts would strain to interpret them as narrowly as possible.[47]

In any event, the claim the IRS finally chose to pursue was the 1981 debt discharge claim. Had the case begun with a policy decision to attempt to establish that discharges of gambling debt are taxable, *Zarin* might not have been the best test case. As it happened, the IRS's ambivalence as to how to proceed placed it at a procedural disadvantage.

B. The Creation of Facts

Once an issue is joined, the next major step in most lawsuits is fact-finding. In theory, facts are facts and law is law. Facts are found by the trial court and may not be disturbed on review unless they are clearly erroneous. In *Zarin*, all of the facts were stipulated.[48] In the Tax Court, parties are required, wherever possible, to stipulate with respect to both evidentiary facts and the application of law to facts.[49] Such a stipulation is treated as a conclusive admission by the parties,[50] except to the extent the stipulation is contrary to statute.[51] In a stipulated case there is very little fact-finding for a trial court to do, except perhaps to draw inferences.

Theory and practice, however, often diverge. A neat demarcation between fact and law is easier to maintain when the law is clear. When the law is unclear, the line becomes foggy. Counsel may omit facts that are ultimately deemed relevant, the stipulation may be ambiguous in critical regards, and the court itself may be reluctant to accept the parties' stipulations, notwithstanding its own rules. All of these problems arose in *Zarin*.

Among the issues as to which the *Zarin* stipulation was silent or ambiguous were: (1) whether Zarin's "debt" to Resorts was enforceable as a

47. The Tax Court and the Seventh Circuit had both recently limited the scope of the AMT rules as applied to gambling losses. Groetzinger v. Comm'r, 82 T.C. 793, 795 (1984), *aff'd*, 771 F.2d 269 (7th Cir. 1985), *aff'd*, 480 U.S. 23 (1987).

48. *See generally* Stipulation, *supra* note 1. The Stipulation consisted of a series of factual recitals, most of which also appeared in the Tax Court's factual findings, plus fourteen attached exhibits: (1) Zarin's 1980 tax return, (2) Zarin's 1981 tax return, (3) the IRS's notice of deficiency for 1980 and 1981, (4) excerpts from Staff Policy Group on Casino Gambling, Second Interim Report (Feb. 17, 1977), (5) Zarin's credit application, (6) a sample marker, (7) Resort's records of Zarin's credit transactions, consisting of ninety-four often illegible pages, (8) the Complaint in N.J. Division of Gaming Enforcement v. Resorts Int'l Hotel, Inc., Docket No. 81-19 (N.J. Casino Control Comm.), (9) an Emergency Order issued by the Casino Control Commission in that case, (10) the Complaint in Resorts Int'l Hotel, Inc. v. Zarin, Docket No. L-14602-80 (N.J. Super. Ct. Atl. Cty Div. 1980), (11) the Answer in the foregoing case, (12) the Settlement and Security Agreement between Zarin and Resorts settling the foregoing case and Zarin v. Resorts Int'l Hotel, Inc., No. 80-3972 (D.N.J. 1980), (13) the Final Order in N.J. Division of Gaming Enforcement v. Resorts Int'l Hotel, Inc., No. 81-19 (N.J. Casino Control Comm. 1983), and (14) psychiatric reports on Zarin's compulsive gambling behavior by Drs. Robert T. Latimer and Robert L. Custer.

49. *See* Tax Ct. R. 91(a)(1).

50. *See id.* 91(e).

51. *See* Ohio Clover Leaf Dairy Co. v. Comm'r, 8 B.T.A. 1249, 1255 (1927); Harold Dubroff, The United States Tax Court: An Historical Analysis 278 (1979).

matter of New Jersey law, (2) the value of the chips or other goods or services received by Zarin in exchange for his debt, and (3) whether Zarin was solvent at the time of the asserted debt discharge.

1. Enforceability

Because casino gambling was new to New Jersey, state law governing the enforceability of casino debts was not well-settled. In addition, the relevant credit records were tortuous and often illegible. The principal evidence that Zarin had "borrowed" $3,435,000 was that he had given an unspecified number of checks or markers totaling that amount to Resorts between April 17 and April 29, 1980.[52] Exactly how these late April checks related to his four months of gambling was unclear. As of April 29, Zarin's credit reference card itself reflected an outstanding balance of only $305,000. In separate litigation before the Casino Control Commission, Resorts itself ultimately admitted to violating New Jersey law on thirteen occasions in extending credit to Zarin during the first four months of 1980. Which, if any, of the various checks and markers involved in the tax litigation were also involved in those violations, however, was unclear.

The Tax Court therefore resolved the enforceability issue by appealing to the IRS's burden of proof. In the ordinary tax case, the burden lies with taxpayer; factual omissions are resolved in the IRS's favor.[53] In *Zarin*, however, because the IRS had chosen to pursue a different claim at trial than that specified in its notice of deficiency, the burden of proof on the debt discharge claim lay with the IRS.[54] On this basis, and this basis alone, the Tax Court found that Zarin's debt was unenforceable.[55] Had the IRS asserted the 1981 debt discharge claim in its notice of deficiency, the burden of proof would have rested on Zarin. It is unclear how the Tax Court would then have resolved the enforceability issue.

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52. Whether a stipulation that Zarin had written checks to Resorts was sufficient to establish a prima facie case that he owed that same amount to Resorts is a more difficult question than one might expect. Since the adoption of the Uniform Commercial Code, Article 3 generally imposes secondary liability on the part of the drawer of a check if the bank on which the check is drawn fails to honor it. Because New Jersey gaming laws severely restricted the transfer of checks given for gambling credit, however, Article 3 of the UCC was held not apply to such checks. Resorts Int'l Hotel, Inc. v. Salomone, 178 N.J. Super. 598, 604-05 (1980). Therefore, such checks are subject to pre-UCC law. Prior to adoption of the UCC, New Jersey recognized a rebuttable presumption, applicable when a check was introduced as evidence of an underlying debt, that the drawer of the check was indebted to the payee at the time he gave it. *See* Bunting v. Allen, 18 N.J.L. 299, 300 (1841). Rule 302 of the Federal Rules of Evidence, made applicable by Tax Court Rule 143, provides that the same presumption will apply in the Tax Court with respect to facts that are elements of a claim as to which state law supplies the rule of decision. Whether the existence of a "debt" for purposes of the debt discharge doctrine is a question of state law, however, is not clear and may turn on whether one adopts a "net worth" or "loan proceeds" theory of that doctrine. *See infra* note 91 and accompanying text.

53. TAX CT. R. 142(a).

54. *See* Zarin v. Comm'r, 92 T.C. 1084, 1088-89 (1989), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990); TAX CT. R. 142(a).

55. *Zarin*, 92 T.C. at 1090.

Why is this important? A rule of law must work in practice, not merely in theory. In a suit to enforce checks and markers, a casino may eventually be able to prove liability on the basis of its own hastily scrawled credit reference cards. For the gambler or the IRS, however, the evidentiary problems are enormous. As a result, if the tax consequences of a discharge of casino gambling debt are made to turn on enforceability, the outcome in cases like *Zarin* may effectively be determined by reference to which party bears the burden of proof. Such a rule would be profoundly unsatisfactory. One can imagine cases in which the casino concedes the substantive dispute because it cannot prove enforceability, but the gambler loses the subsequent tax case because he cannot prove *un*enforceability—all with respect to the same debt. Any rule structure, however theoretically sound, that ignores such evidentiary problems is unlikely to command long-term respect.

One might be tempted to suggest that the court could have inferred unenforceability from the fact of the settlement itself. After all, one might argue, why else would Resorts have relinquished a claim to $2.935 million? There are at least two problems with this solution.

The first problem is legal. The IRS is not bound either by a judgment in the court hearing the substantive dispute or by a settlement in lieu of judgment, because it is not party to the substantive proceeding.[56] A less binding approach might be to treat the substantive judgment or settlement as prima facie evidence of whatever it holds or states, shifting the burden of going forward to the IRS. Courts, however, have not yet adopted such a rule.[57] Currently, the burden remains on taxpayer to prove *de novo* what was already proved (or was to be proved) in the substantive proceeding.

The second problem is practical. We may guess that Resorts settled because it concluded that its claim was unenforceable, but in fact it may have settled for other reasons. Zarin's answer in state court, for example, asserted *inter alia* that there was no debt, enforceable or otherwise, because Resorts had never intended that any amount owed by Zarin be collectible or collected.[58] Alternatively, he asserted that the debt had been repaid in part or in full.[59] Resorts' willingness to settle might

56. *See generally* Gerald A. Kafka & Rita A. Cavanagh, Litigation of Federal Civil Tax Controversies § 22.03 (1996) (discussing collateral estoppel in Tax Court litigation).

57. In limited circumstances, a showing by taxpayer that the Commissioner's determination was arbitrary or erroneous operates to shift the burden of going forward to the Commissioner. *See, e.g.*, Moretti v. Comm'r, 77 F.3d 637, 643 (2d Cir. 1996); Demkowicz v. Comm'r, 551 F.2d 929, 931 (3d Cir. 1977). *See generally* Sean M. Moran, Note, *The Presumption of Correctness: Should the Commissioner Be Required to Carry the Initial Burden of Production*, 55 Fordham L. Rev. 1087 (1987); Christina Potter Moraski, *Proving a Negative—When the Taxpayer Denies Receipt*, 70 Cornell L. Rev. 141 (1984).

58. Answer at 6, Resorts Int'l Hotel Casino, Inc. v. Zarin, No. L-14602-80 (N.J. Super. Ct. Atl. City Div. 1980).

59. *Id.*

equally be construed as a recognition of the validity of one of these claims—with different tax consequences.

2. *Value*

Another set of problems was raised by the issue of how much value Zarin received in exchange for his $3,435,000 in checks. Value is normally a question of fact.[60] The Stipulation, however, was silent as to value. The Tax Court, therefore, had three options: it could (1) invoke the burden of proof and hold against the IRS, (2) infer a value from the stipulated facts, or (3) assign a value as a matter of law. The court declined to invoke the burden of proof. Whether it inferred a value from the stipulated facts or assigned one as a matter of law was not clear.

In form, the case proceeded on the assumption that the checks had been issued for chips—not, for example, for cash or hotel accommodations. What are chips? The Stipulation stated that "chips are property which are not negotiable and may not be used to gamble or for any other purpose outside the casino where they were issued."[61] Apart from this stipulation, the Tax Court had no further guidance; it relied instead on its own understanding of how casinos operate. On this basis, it assumed that Zarin could have redeemed his chips dollar-for-dollar for cash.[62] It therefore concluded that the actual value of Zarin's chips exactly equaled their face value—$3,435,000.[63]

Unfortunately, the court's key assumption was wrong. 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.[64] In effect, the only thing Zarin could have done with his chips was to pay down his unenforceable debt. On this basis, the Third Circuit concluded that the chips had no "independent economic value beyond the casino"[65]—indeed, that they had "no economic substance."[66] Whether it so held as a matter of law or because it believed that the Tax Court was clearly erroneous on the facts was again not clear.

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60. *See, e.g.*, Elmhurst Cemetery Co. v. Comm'r, 300 U.S. 37, 40 (1937); Anselmo v. Comm'r, 757 F.2d 1208, 1213 (11th Cir. 1985); Ellstrom v. Comm'r 235 F.2d 181, 181 (6th Cir. 1956); Tex.-Empire Pipe Line Co. v. Comm'r, 141 F.2d 326, 327-28 (10th Cir. 1944); Anchor Co. v. Comm'r, 42 F.2d 99, 100 (4th Cir. 1930).

61. Stipulation, *supra* note 1, at 4.

62. Zarin v. Comm'r, 92 T.C. 1084, 1092 (1989) (finding that "theoretically petitioner could have redeemed the chips for cash"), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990).

63. *See id.* at 1100 (stating that "[f]oreign currency fluctuates in United States dollar value, whereas the chips in question do not").

64. *See* N.J. ADMIN. CODE § 19:45-1.24(s) (1979) (providing that "[t]he casino licensee shall require patrons to apply any chips . . . in their possession in reduction of personal checks or [markers] exchanged for purposes of gaming prior to exchanging such chips . . . for cash . . . or prior to departing from the casino area").

65. Zarin v. Comm'r, 916 F.2d 110, 114 (3d Cir. 1990).

66. *Id.*

The Tax Court majority, however, further found or held that in actuality, Zarin had not purchased chips at all:

> [Zarin] bargained for and received the opportunity to gamble and incidental services, lodging, entertainment, meals, and transportation. Petitioner's argument that he was purchasing chips ignores the essence of the transaction . . . . As a matter of substance, chips in isolation are not what petitioner purchased.[67]

Unfortunately, there was no stipulation as to the value of any of these services, which, unlike chips, are not issued in dollar denominations.[68] The only evidence of their value was the fact that Zarin had "paid" $3,435,000 for them. It is not clear whether the Tax Court valued the chips, the services, or both together. In any event, the court either inferred the value of whatever Zarin received from the amount he paid or held that amount to be its value as a matter of law.

A colorable argument can be made in support of such an inference or holding. "Fair market value" is formally defined, for tax purposes, as the price for which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.[69] Nevertheless, in an arm's-length sale between unrelated parties the value of an item is almost always determined by reference to the price actually paid.[70]

There were, however, at least three problems with the application of these rules to the *Zarin* facts. First, it was stipulated that Zarin was acting under compulsion[71] and that he had no knowledge of the amount he was paying[72]—a "relevant fact" within the meaning of the formal definition of fair market value. Second, the rule that the value of an item is determined by reference to the price actually paid was not designed to apply to the valuation of an "opportunity to gamble." It may be plausible to infer that someone who has paid $3.435 million for a painting has received $3.435 million of value. It is far less plausible to infer that someone who has just lost $3.435 million on a bet has received equal value.

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67. *Zarin*, 92 T.C. at 1099.

68. Resorts estimated that the value of the incidental services, lodging, entertainment, meals, and transportation given to Zarin was $180,000. *See* Skakun, *supra* note 31. This value, however, was not in evidence in the Tax Court litigation.

69. United States v. Cartwright, 411 U.S. 546, 551 (1973); Willow Terrance Dev. Co. v. Comm'r, 345 F.2d 933, 936 (5th Cir. 1965), *cert. denied*, 382 U.S. 938 (1965); Treas. Reg. § 1.170A-1(c)(2) (1972); Treas. Reg. § 1.412(c)(2)-1(c)(1) (1980); Treas. Reg. § 1.897-1(o)2(ii) (1980); Treas. Reg. § 1.1445-1(f)(7) (1986); Treas. Reg. § 20.2031-1(b) (1958); Treas. Reg. § 20.2031-3 (1958); Treas. Reg. § 20.2031-6(a) (1958); Treas. Reg. § 25.2512-1 (1958); Treas. Reg. § 2512-3(a) (1958); Treas. Reg. § 25.2702-2(c)(1) (1960); Treas. Reg. § 31.3121(i)-4 Example (1) (1954).

70. *See* Husted v. Comm'r, 47 T.C. 664, 673 (1967); Hunley v. Comm'r, 25 T.C.M. (CCH) 355, 355 (1966); Pellar v. Comm'r, 25 T.C. 299, 309 (1955); Palmer v. Comm'r, 302 U.S. 63, 67 (1937).

71. *See* Stipulation, *supra* note 1, at 11 (stating that "Zarin was at that time possessed by the compulsion to continue gambling").

72. *See id.* (stating that "Zarin was not aware of the amount of his gambling debts."); *id.* at 13 (stating that in early May 1980, "the amount of the debt was not yet known").

Most importantly, however, the rule simply cannot be used to measure value for debt discharge purposes. When 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. If the original price is the item's deemed value, then the discharge will represent income. If, however, the adjusted price is the item's deemed value, then the discharge merely brings the price actually paid into line with the item's deemed value. The fact that taxpayer originally agrees to pay $3.435 million does not by itself resolve the question. Rather, we need extrinsic evidence of value.

The strongest argument in favor of the Tax Court majority's valuation was that Zarin received the same value that a gambler who had lost $3.435 million of his own money would have received. This may be true, but it does not follow that either gambler (or, indeed, a neutral observer) would necessarily conclude, after the fact, that he received $3.435 million worth of anything. I will discuss the problem of value further in Part II.C below.

3. Solvency

Internal Revenue Code § 108(e)(5),[73] the statutory purchase price adjustment provision, is available only to solvent taxpayers. Attempting to invoke this provision, Zarin's trial counsel stated in brief that "[o]n September 28, 1981 when Petitioner settled his debt with Resorts, he was solvent."[74] There was, however, no stipulation or other evidence to that effect; and statements in briefs are not evidence.[75] Counsel's assertion was unfortunate for other reasons as well: (1) Zarin later declared under oath that he had not authorized the statement,[76] (2) he also later filed affidavits and financial statements to the effect that he was *insolvent* both before and after the discharge,[77] and (3) insolvent taxpayers are exempt *per se* from the recognition of discharge of indebtedness income.[78] (Zarin also later to sued trial counsel for its handling of the insolvency issue.)[79]

Perhaps there are cases in which fact-finding is straightforward. *Zarin*, however, was not such a case. When Judge Jacobs stated, in dissent, "[t]he facts in this case are relatively simple," he was referring to the stylized facts—the facts for which *Zarin* has come to stand. He was not referring to reality.

73. All section references, unless otherwise indicated, are to the Internal Revenue Code of 1954, as in effect in 1980 and 1981.

74. Brief for Petitioner at 79, Zarin v. Comm'r, 92 T.C. 1084 (1989) (No. 21371-86).

75. *See* Tax Ct. R. 143(b).

76. *See* Affidavit of David Zarin at 2, *Zarin*, 92 T.C. 1084 (No. 21371-86).

77. *See id.* at 1-3; Affidavit of Gordon M. Sandler, *Zarin*, 92 T.C. 1084 (No. 21371-86) (Zarin's certified public accountant); Affidavit of Jonathan I. Epstein, *Zarin*, 92 T.C. 1084 (No. 21371-86) (Zarin's personal and business counsel).

78. I.R.C. § 108(a) (1980).

79. Zarin v. Reid & Priest, 184 A.D.2d 385, 387 (N.Y. App. Div. 1992) (finding no cause of action for legal malpractice because taxpayer ultimately won in the Third Circuit).

C. The Indeterminacy of Rules

No one who believes that courts merely apply rules to facts would be able to explain what the authors of the various *Zarin* opinions thought they were doing. What judges do (and lawyers try to persuade them to do) is far more complex, as *Zarin* richly illustrates.

The rule structure the Tax Court and Third Circuit inherited was complex and ill-defined. The discharge of indebtedness doctrine itself had been created by the courts, not Congress, in *United States v. Kirby Lumber Co.*,[80] decided in 1931.[81] As in *Zarin*, the actual facts in *Kirby Lumber* were more complex than those for which the case ultimately came to stand.[82] Here I will discuss the latter—the stylized facts. Taxpayer issued notes for cash; it was later able to repurchase those notes for less than their face amount. At least on these stylized facts, taxpayer ended up with more money.[83] Therefore, the Supreme Court held, Taxpayer recognized income.

Subsequent cases recognized several possibly relevant exceptions to this general rule. The first exception applied to insolvent taxpayers: courts reasoned that the discharge of insolvent taxpayers' debts did not make them wealthier and therefore concluded that such taxpayers could not have discharge of indebtedness income.[84] Courts also developed an

80. 284 U.S. 1, 3 (1931).

81. The Treasury first attempted to tax debt discharge income by regulatory fiat. Although early regulations only required the inclusion of limited types of such income, *see* Treas. Reg. 33, art. 135 (Revenue Act of 1913 Pub. L. No. 63-16, 38 Stat. 114); Treas. Reg. 33 (rev. ed.), arts. 149, 150, 152 (Revenue Acts of 1916, Pub. L. No. 64-271, 39 Stat. 756, and 1917, Pub. L. No. 65-70, 40 Stat. 300), the 1918 regulations took the position that debt discharges generally resulted in income. *See* Treas. Reg. 45, art. 544 (Revenue Act of 1918, Pub. L. No. 65-254, 40 Stat. 1057). The issue initially had a mixed reception in the courts. In *United States v. Oregon-Washington Railroad & Navigation Co.*, 251 F. 211, 213 (2d Cir. 1918), the court treated the cancellation of a corporation's debt to its shareholder as a contribution to capital, not income. In *Great Northern Railway Co. v. Lynch*, 292 F. 903, 906 (D. Minn. 1921), by contrast, the court found income when the taxpayer wrote off liabilities that had become outlawed. In 1926, however, the Supreme Court decided *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 175 (1926), which the Board of Tax Appeals interpreted to hold that debt discharges did not trigger income. *See, e.g.*, Senner v. Comm'r, 22 B.T.A. 655 (1931); Houghton & Dutton Bldg. Trust v. Comm'r, 20 B.T.A. 591, 593 (1930); Meyer Jewelry Co. v. Comm'r, 3 B.T.A. 1319, 1321-22 (1926); Indep. Brewing Co. v. Comm'r, 4 B.T.A. 870, 872-73 (1926). A more extensive discussion of *Kerbaugh-Empire* appears in Seto, *supra* note 26, at 208-10. The issue was finally resolved in *Kirby Lumber*.

82. *See* Boris I. Bittker, *Income from the Cancellation of Indebtedness: A Historical Footnote to the* Kirby Lumber Co. *Case*, 4 J. Corp. Tax'n 124 (1977) (explaining that in *Kirby Lumber*, the debt was actually issued primarily to redeem preferred stock with accrued but unpaid dividends, not for cash).

83. In point of fact, the Kirby Lumber Company ended up with no extra cash at all. The true benefit the company obtained through the issuance and repurchase of the bonds in question was the retirement of outstanding preferred stock for less than its par value plus accrued dividends. The Supreme Court ignored the more difficult issues presented by this more complex picture of what had occurred. As I note at the outset of this Article, law involves simplification. Whether the degree of such simplification is warranted in a given case is always open to question.

84. *See, e.g.*, Haden Co. v. Comm'r, 118 F.2d 285, 286 (5th Cir. 1941), *cert. denied*, 314 U.S. 622 (1941) (finding that a taxpayer recognizes income to extent debt discharge renders the taxpayer solvent); Dallas Transfer & Terminal Warehouse Co. v. Comm'r, 70 F.2d

exception for purchase price adjustments: a discharge of purchase money debt might, in fact, constitute an adjustment to the price and basis of the purchased property rather than income.[85] One 1939 Board of Tax Appeals case, *N. Sobel, Inc. v. Commissioner*,[86] was interpreted as holding that the settlement of disputed debts did not result in income—a rule sometimes known as the disputed debt exception to the doctrine.[87]

Congress intervened sporadically, primarily through the enactment and repeated amendment of what is now § 108. In 1954, debt discharge income was added to the list of types of gross income in § 61; this addition, however, seems to have been made for the sake of completeness and had no apparent substantive effect.[88] Section 108(a), enacted in 1980, replaced the judicially-created insolvency exception with new statutory rules that explicitly superseded prior law.[89] At the same time, Congress added § 108(e)(5), a statutory purchase price adjustment exception. Unlike § 108(a), this new exception was not described as exclusive. It apparently supplemented rather than replaced the broader nonstatutory rules.[90]

On top of this judicial and statutory pastiche, courts and scholars created two competing theoretical rationales for the doctrine. The first, known as the "net worth" or "freeing of assets" theory, held that a taxpayer recognized income at the moment of discharge because his or her net worth was increased by that discharge. The second theory, known as the "loan proceeds" or "deferred income" theory, focused on the borrowing rather than on the discharge. Borrowing does not result in income, it

95, 96 (5th Cir. 1934) (noting that the discharge of debts of insolvent taxpayer does not result in recognition of income); F.W. Sickels Co. v. United States, 31 F. Supp. 654, 659 (Ct. Cl. 1940) (discussing when the IRS first conceded the insolvency exception); Lakeland Grocery Co. v. Comm'r, 36 B.T.A. 289, 291 (1937).

85. *See, e.g.*, Comm'r v. Sherman, 135 F.2d 68 (6th Cir. 1943); Helvering v. A.L. Killian Co., 128 F.2d 433, 434-35 (8th Cir. 1942); Allen v. Courts, 127 F.2d 127, 128 (5th Cir. 1942); Hirsch v. Comm'r, 115 F.2d 656, 658 (7th Cir. 1940); Burnet v. John F. Campbell Co., 50 F.2d 487 (D.C. Cir. 1931); Gehring Publ'g Co. v. Comm'r, 1 T.C. 345, 354 (1942). *See also* Helvering v. Am. Dental Co., 318 U.S. 322, 327-28 (1943) (stating that "[w]here the indebtedness has represented the purchase price of property, a partial forgiveness has been treated as a readjustment of the contract rather than a gain").

86. 40 B.T.A. 1263, 1265 (1939).

87. *See, e.g.*, Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates & Gifts ¶ 6.4.2 (2d ed. 1989); David J. Blattner, Jr., *Debt Cancellation*, 30th Ann. N.Y.U. Inst. 237, 253; James S. Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225, 237 (1959); Victoria Powell, *A Review of Judicial Exceptions to the* Kirby Lumber *Rule*, 30 U. Fla. L. Rev. 94, 120 (1977).

88. A proposal by the House of Representatives to add a new Code § 72 to clarify and define the doctrine, *see* H.R. Rep. No. 83-1337, at 12 (1954), was rejected by the Senate and therefore did not make it into the Internal Revenue Code of 1954 as finally enacted. *See* H.R. Rep. No. 83-2543, at 23 (1954); *Hearing on H.R. 8300 Before the S. Comm. on Finance*, 83d Cong. 624-26 (1954) (statement of the Ass'n of the Bar of the City of New York) (opposing statutory clarification and recommending continued case law elaboration).

89. I.R.C. § 108(e)(1) (1980) (finding that there is no insolvency exception except as provided in IRC § 108(a)).

90. *See* Seto, *supra* note 26, at 266-70.

argued, because of an assumption that the loan will be repaid; when this assumption proves false—for example, when the debt is discharged without repayment—a taxpayer must recognize the income he or she would otherwise have recognized at the moment of borrowing.

At the trial level, Zarin invoked the net worth theory. His alleged debt to Resorts, he argued, was unenforceable from the outset as a matter of state law. Its discharge, therefore, had no effect whatsoever on his net worth and could not result in debt discharge income.[91] In addition, he invoked two exceptions to the doctrine. First, he argued that his alleged debt to Resorts was disputed, and therefore exempt under the disputed debt exception.[92] Second, he argued that the settlement was exempt under § 108(e)(5), the statutory purchase price adjustment exception.[93] Finally, Zarin argued that he ought to be allowed to use his 1980 gambling losses to offset any 1981 income recognized by reason of the discharge, an argument which was flatly inconsistent with the governing regulations and which he did not thereafter seriously pursue.[94] Zarin did not initially argue insolvency, nor did he attempt to invoke the nonstatutory purchase price adjustment rules.

The IRS, by contrast, argued the loan proceeds theory. Zarin was not required to include the borrowed $3,435,000 in income at the time of borrowing because it was assumed that the same amount would be repaid. When that assumption proved false in 1981, the IRS argued, Zarin should be required to report the unrepaid loan proceeds—$2,935,000—as income. Under the loan proceeds theory, in other words, enforceability was irrelevant.[95] The disputed debt exception, the IRS argued further, applied merely to disputes about contract liability;[96] § 108, it asserted, was limited to trade or business debt,[97] and there was no provision allowing the carryover of Zarin's 1980 losses to offset any 1981 income.[98]

1. *The Tax Court Majority*

The Tax Court majority agreed with the IRS on all major points, although often for different reasons. With respect to enforceability, it reasoned:

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91. *See* Opening Brief for Petitioner at 62-63, Zarin v. Comm'r, 92 T.C. 1084 (1989) (No. 21371-86).

92. *See id.* at 40-44.

93. *See id.* at 77-79.

94. *See id.* at 83-84. Treas. Reg. § 1.165-10 provides that losses on wagering transactions can be deducted only to the extent of gain *during the same taxable year* from such wagering transactions. Treas. Reg. § 1.165-10 (1960).

95. *See* Brief for Respondent at 15-25, *Zarin*, 92 T.C. 1084 (No. 21371-86).

96. *See id.* at 21.

97. *See* Reply Brief for Respondent at 13, *Zarin*, 92 T.C. 1084 (No. 21371-86). For this proposition, the IRS cited Treas. Reg. §1.108(a)-1, which spoke only to the applicability of I.R.C. § 108(a), dated from 1956, and had not been amended to reflect any changes in the statute since that date.

98. *See* Reply Brief for Respondent at 14a, *Zarin*, 92 T.C. 1084 (No. 21371-86).

> In the instant case, 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. Petitioner received credit of $3,435,000 from Resorts. He treated these amounts as a loan, not reporting any income on his 1980 tax return.[99]

Therefore, it concluded, he should be required to treat the loan, although unenforceable, as debt for debt discharge purposes as well.[100]

Zarin's other arguments fared no better. The disputed debt exception, the court suggested, applied only to unliquidated debts; Zarin's debt was liquidated.[101] Section 108(e)(5) was inapplicable for two reasons. First, in substance Zarin had purchased "the opportunity to gamble and incidental services, lodging, entertainment, meals, and transportation," which, the court said, did not constitute "normal commercial property"[102] covered by that section. Second, the court found that chips could not fluctuate in value, implying that § 108(e)(5) applied only to property susceptible to such value fluctuation.[103] Finally, the court held that Zarin's gambling losses could not offset his debt discharge income because (1) the losses were incurred in 1980 and the income in 1981, and (2) the debt discharge income was not a gain from "wagering transactions" within the meaning of § 165(d), which limits the deduction of wagering losses to such gains, even within the same year.[104]

The 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.[105] Its reading of § 108(e)(5), as Judge Ruwe's dissenting opinion would demonstrate, violated conventional canons of statutory construction. Only its refusal to allow Zarin to apply his gambling losses against his debt discharge income seemed uncontroversial. What did the majority think it was doing?

Lawyers, judges, and legal scholars are constantly driven to explain. Perhaps as a result, larger theories often come to underlie more concrete rules, whether statutory or judicial. As theories evolve, they sometimes come into conflict with parts of the very rules they were created to explain. The lure of theory is powerful indeed. In *Zarin*, theory suggested that the taxpayer had received taxable consumption value. The Tax Court majority clearly wanted to construe the debt discharge rules in a manner consistent with theory and was willing to disregard at least some precedent to do so.

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99. *Zarin*, 92 T.C. at 1092.
100. *Id.* at 1095.
101. *Id.*
102. *Id.* at 1099.
103. *Id.* 1097, 1100.
104. *Id.* at 1096.
105. *See* United States v. Hall, 307 F.2d 238, 241 (10th Cir. 1962) (finding that discharge of unenforceable gambling debt not income); N. Sobel, Inc. v. Comm'r, 40 B.T.A. 1263, 1265 (1939) (providing that settlement of disputed debt not income).

I will discuss theory at greater length in Part II of this Article. Here, I want to focus on a more technical question: In attempting to conform law to theory, just how much precedent did the Tax Court majority disregard? One of the functions of a good opinion is to resolve the issues presented, preferably in the "right" way, while doing minimum violence to existing law—to weave its logic, to the extent possible, within the existing legal fabric. Perhaps the single greatest failing of the majority opinion was its failure to appreciate the collateral implications of its logic.

I have suggested that, in the casino context, unenforceability may be difficult to prove. Nevertheless, from a precedential perspective, one of the key questions in *Zarin* was whether the debt discharge rules should be extended to unenforceable debt. No court had ever done so. Indeed, no court had ever treated an unenforceable obligation as "debt" for any other tax purpose. Interest paid on unenforceable debt was not deductible.[106] A bad debt deduction was allowable only with respect to enforceable debt.[107] Payment of an unenforceable obligation was not deductible as a tax under § 164,[108] a loss under § 165,[109] or a restoration of an item previously included under claim of right under § 1341.[110] In holding that *consistency* required Zarin's unenforceable obligation to be treated as "debt" for debt discharge purposes, the Tax Court necessarily implied that it should be treated as debt for other purposes as well.[111] The impli-

106. *See, e.g.*, Autenreith v. Comm'r, 115 F.2d 856, 858 (3d Cir. 1940); Rev. Rul. 82-78, 1982-1 C.B. 30 (providing that "[a]n indebtedness, for purposes of § 163, is an unconditional and legally enforceable obligation for the payment of money"); Rev. Rul. 78-29, 1978-1 C.B. 62; Rev. Rul. 77-417, 1977-2 C.B. 60; Rev. Rul. 77-110, 1977-1 C.B. 58, 59; Rev. Rul. 74-592, 1974-2 C.B. 48.

107. *See* Comm'r v. McKay Prods. Corp., 178 F.2d 639, 644-45 (3d Cir. 1949), *cert. dismissed*, 339 U.S. 961 (1950); Treas. Reg. § 1.166-1(c) (as amended in 1986) (providing that "[a] bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money"). The latter regulation was amended in 1983, after the IRS's victories in *Flamingo Resort, Inc. v. United States*, 664 F.2d 1387, 1390-91 (9th Cir. 1982), *cert. denied*, 459 U.S. 1036 (1982), and *Desert Palace, Inc. v. Comm'r*, 698 F.2d 1229, 1229 (9th Cir. 1982), *cert. denied*, 464 U.S. 816 (1983), to provide:

> A debt arising out of the receivables of an accrual method taxpayer is deemed to be an enforceable obligation for purposes of the preceding sentence to the extent that the income such debt represents have been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year. For example, a debt arising out of gambling receivables that are unenforceable under state or local law, which an accrual method taxpayer includes in income under section 61, is an enforceable obligation for purposes of this paragraph.

Treas. Reg. § 1.66-1(c) (as amended by T.D. 7902, 1983-2 C.B. 45). This was and still is, to my knowledge, the only exception to the general rule that debt must be enforceable to be treated as "debt" for tax purposes.

108. *See* Cooperstown Corp. v. Comm'r, 144 F.2d 693, 696 (3d Cir. 1944), *cert. denied*, 323 U.S. 772 (1944).

109. *See* Murphree v. United States, 867 F.2d 883, 886 (5th Cir. 1989); Comm'r v. Gilt Edge Textile Corp., 173 F.2d 801, 804 (3d Cir. 1949); Rev. Rul. 78-141, 1978-1 C.B. 58; Rev. Rul. 62-14, 1962-1 C.B. 11.

110. *See* Kappel v. United States, 437 F.2d 1222, 1226 (3d Cir. 1971), *cert. denied*, 404 U.S. 830 (1971).

111. Zarin v. Comm'r, 92 T.C. 1084, 1092 (1989), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990).

cations were potentially far-reaching.

Consider, for example, the following hypothetical. After incurring his "debt" but before settling it, Zarin incorporates his gambling business. In the transaction, the new corporation assumes the "liability."[112] If the "liability" assumed exceeds the basis of any property contributed, we must decide whether Zarin recognizes gain under § 357(c).[113] If the answer is no—that is, if we are unwilling to treat unenforceable debt as a "liability" for purposes of the corporate nonrecognition rules—circumvention of the Tax Court majority's holding becomes trivial.[114] If, on the other hand, unenforceable purchase money debt is a "liability" for purposes of § 357(c), consistency requires that Zarin also be allowed basis for that "liability."[115] Do we really believe that *Commissioner v. Tufts*[116] should be so extended? Must we also then be willing to discard *Estate of Franklin v. Commissioner*?[117]

The point here is not that the Tax Court majority was "wrong," nor even that its opinion causes problems in the interpretation of § 357(c). That section is merely one of many for which the definition of debt is crucial. The point is rather that the opinion's logic is not easily limited to the *discharge* of unenforceable debts. The premise that debt must be enforceable to be "debt" is fundamental to our current tax system; changes in fundamental rules are hard to limit to particular contexts.

Even more fundamental are the basic accounting rules. To some, the term "accounting" evokes images of bare light bulbs and green eyeshades. Accounting rules, however, are the lifeblood of any financial system, and a court construing the Internal Revenue Code ignores them at its peril. Here, again, the Tax Court did inadvertent violence to existing law.

At the heart of the majority opinion was an appeal to accounting consistency—"symmetry," the court called it.[118] The court's real concern, as

112. Readers uncomfortable with the notion of incorporating a gambling business may apply the discussion in text to the following hypothetical, which raises the same issues. Zarin acquires real estate in exchange for debt that is unenforceable *ab initio* as a matter of state law, perhaps because it is usurious. He then incorporates his real estate activities.

113. Section 351 provides nonrecognition treatment to a taxpayer who exchanges property solely for stock of a corporation and ends up in control of the corporation immediately after the exchange. I.R.C. § 351 (West 2006). Section 357(c) then provides that such a taxpayer will nevertheless recognize gain to the extent that any liabilities assumed the corporation in the transaction exceed the basis of any property contributed. *Id.* § 357(c).

114. I leave this problem as an exercise for the student.

115. Assume, for example, that Zarin incorporates after obtaining the chips for unenforceable debt but before he loses them at craps. The new corporation takes the chips and assumes the "debt." Unless Zarin gets basis in those chips for that unenforceable debt, § 357(c) will trigger gain where it clearly should not.

116. 461 U.S. 300, 317 (1983) (discussing that a taxpayer obtains basis in property for nonrecourse purchase money debt).

117. 544 F.2d 1045, 1045 (9th Cir. 1976) (finding that debt is not debt if it "has economic significance only if the property substantially appreciates in value prior to the date at which a very large portion of the purchase price is to be discharged").

118. Zarin v. Comm'r, 92 T.C. 1084, 1092 (1989), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990).

I have noted, was the correct measurement of income; the court concluded that Zarin had received consumption value without paying for it and used the debt discharge rules to tax him on that value.[119] Its argument, however, was framed in terms of consistency, a conceptually distinct issue,[120] and it is to this topic that I now turn.

I want to focus particularly on the need for consistency between the loss recognition rules and the debt discharge rules. The problem is perhaps more easily explored in a non-gambling context. Assume that Zarin incurs $3.435 million of fully enforceable debt in 1980 for an ordinary and necessary business expense deductible under § 162.[121] In 1981, that debt is then discharged for a payment of $500,000. There are two ways to account consistently for this transaction. First, we might allow a $3.435 million deduction in 1980, treat the allowed amount as a liability, and require the recognition of $2.935 million of income in 1981. Alternatively, we might prohibit recognition of any expense in 1980. In such event, we would not require Zarin to recognize debt discharge income in 1981; indeed, we would even permit him to take into account a $500,000 expense when he pays the $500,000 settlement amount.[122]

In substance, over the transaction as a whole, Zarin has spent $500,000 on a deductible item. If we account *inconsistently* for the two events—the incurring of the debt and the partial discharge—we will mismeasure his net income over time. For example, if we require recognition of $2.935 million of debt discharge income in 1981, our loss accounting rules *must* permit Zarin to take a $3.435 million expense into account in 1980.[123] This does not mean that the $3.435 million will necessarily be deductible; it might, for example, be nondeductible as a bribe or lobbying expense. It must, however, be *taken into account* in 1980. Conversely, if our loss accounting rules do not permit Zarin to take a $3.435 million expense into account in 1980, our debt discharge rules *cannot* require him to recognize $2.935 million of income in 1981. This is not because the debt discharge income is exempt; it is required rather as a matter of accounting consistency.

The same consistency requirements apply in accounting for consumption. Assume, for example, that Zarin incurs $3.435 million of enforceable debt for an activity not engaged in for profit (a hobby) in 1980; in 1981 the debt is then settled with a payment of $500,000. If Zarin's method of accounting takes the $3.435 million expenditure into account

119. *Id.* at 1094.

120. A set of accounting rules may be internally consistent but fail to correctly measure income; conversely, a rule of decision may measure income correctly in a given case even though it is inconsistent with the remainder of the tax system.

121. I.R.C. § 162 (1980).

122. We might also prohibit recognition in 1980, but permit recognition of the full $3.435 million of expense in 1981, requiring at the same time the recognition of $2.935 million of income. Such a solution has never been permitted, however, under either the cash or accrual method accounting rules.

123. The consistency problem could also be solved by taking the expense into account at the moment of debt discharge. Existing accounting rules, however, do not so provide.

in 1980, it must also require him to take $2.935 million of debt discharge income into account in 1981. Conversely, if his accounting method does not take the expenditure into account until it is paid, it cannot also require him to account for debt discharge income when payment is made.[124] All this is true even if the hobby expenses turn out to be nondeductible under § 183—applied in the year in which those expenses are taken into account under Zarin's method of accounting. In our system, consistent accounting rules are antecedent to and independent of the substantive rules of inclusion and deduction.

Because the Tax Court concluded that Zarin recognized $2.935 million of debt discharge income in 1981,[125] accounting consistency required that it also hold that he incurred $3.435 million of losses in 1980—nondeductible under § 165(d) because he lacked other gambling income in 1980, but nevertheless to be taken into account in that year.[126] This subsidiary but necessary holding raised a slew of questions. Does a taxpayer incur a loss when he incurs a debt? Does it matter whether he uses the cash or accrual method of accounting? Does it matter whether the debt is enforceable? Does it matter whether the debt is disputed? Or, to put the question in its most pointed form: *Does a cash method taxpayer incur a loss when he incurs but does not pay, a disputed, unenforceable debt?* According to the Tax Court, the answer was yes. It held that Zarin did incur a $3.435 million loss in 1980, regardless of whether he used the cash or accrual method and regardless of whether the debt was enforceable or disputed.[127] And in that holding—necessary both to its conclusion that the 1980 losses could not offset the 1981 debt discharge income and to its conclusion that Zarin had debt discharge income at all—lies the accounting problem.

It is and has always been fundamental to our tax system that a cash method taxpayer does not take otherwise deductible amounts into account until they are actually paid, regardless of whether the obligation to make payment is disputed or legally enforceable.[128] Whether such amounts are in fact deductible is then determined by applying the substantive deductibility rules at the time the expenditures are taken into account—that is, at the time of payment. For example, if Zarin had incurred a debt for hobby expenses in 1980 which he paid in part in 1981, under the cash method the expense would not be taken into account until 1981, only the amount actually paid would be taken into account, and its deductibility would then be determined by applying § 183 in that year. The *Zarin* Tax Court majority ignored this basic rule.

124. Again, the consistency problem could be solved by taking the full $3.435 million expense into account at the moment Zarin pays the $500,000, requiring him at the same time to take into account a $2.935 million debt discharge. Again, existing law does not authorize this solution.

125. Zarin v. Comm'r, 92 T.C. 1084, 1085 (1989), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990).

126. I.R.C. § 165(d) (1980).

127. *Zarin*, 92 T.C. at 1092.

128. Treas. Reg. § 1.461-1(a)(1) (as amended in 1999).

The *Zarin* Stipulation was silent on whether Zarin used the cash or accrual method in his gambling activities. What if he was an accrual method taxpayer? In 1980, an accrual method taxpayer was allowed to take a liability into account when all events had occurred necessary to establish the existence of the liability and the amount of the liability could be determined with reasonable accuracy—the so-called "all events" test. The effect of enforceability under this rule was not clear. It was clear, however, that a contested liability was *not* deductible except to the extent the taxpayer admitted the liability. Instead, the liability was ignored until the dispute was resolved, at which time the resolution was treated as establishing the amount of both the deduction and the debt.[129] This was true regardless of whether, in form, the liability was liquidated or unliquidated. The *Zarin* Tax Court majority ignored this basic rule as well.

Two exceptions to the basic cash and accrual rules were possibly relevant to the *Zarin* facts. First, a taxpayer gets basis in property purchased for debt, even prior to paying off that debt.[130] If the taxpayer then loses the property in an otherwise deductible manner, he or she is entitled to a tax loss even prior to paying off the debt.[131] Use of this exception to rehabilitate the majority's accounting analysis, however, was problematic for at least two reasons. First, the court would have needed to hold that a taxpayer gets basis in property acquired for unenforceable debt. In view of the tax law's general distrust of unenforceable debt,[132] this would have been a fairly radical step.

Second, such a holding would have been inconsistent with established accounting rules for casino chip gambling. At one time, the IRS had advocated a so-called "two-step" approach to casino chip accounting.[133] Under this approach, the conversion of cash or credit into chips and the disposition of the chips were treated as separate steps with independent tax significance. But the Tax Court, the United States District Court for Nevada, and the Ninth Circuit all rejected the two-step approach, requiring instead an accounting approach that disregarded the conversion of cash or credit into chips and treated the disposition of the chips as a disposition of the underlying cash or credit itself.[134] The *Zarin* Tax Court majority's conclusion that chips were merely "a medium of exchange" was therefore fully consistent with existing law—*not* because chips were

129. *See* Dixie Pine Prods. Co. v. Comm'r, 320 U.S. 516, 519 (1944); Treas. Reg. § 1.461-1(a)(2)(ii) (as amended in 1999). *See also* I.R.C. § 461(f); Treas. Reg. § 1.461-2 (as amended in 2004) (establishing special procedure to allow accrual method taxpayers to deduct contested liabilities).

130. *See, e.g.*, Comm'r v. Tufts, 461 U.S. 300, 317 (1983).

131. Treas. Reg. § 1.165-1(c)(1) (as amended in 1977).

132. *See supra* notes 106-10 and accompanying text.

133. *See* I.R.S. Gen. Couns. Mem. 35,796 (May 1, 1974) (revoking I.R.S. Gen. Couns. Mem. 38,536 (Oct. 15, 1980)).

134. *See* Flamingo Resort, Inc. v. United States, 485 F. Supp. 926, 937 (D. Nev. 1980), *aff'd*, 664 F.2d 1387 (9th Cir. 1982), *cert. denied*, 459 U.S. 1036 (1982); Desert Palace, Inc. v. Comm'r, 72 T.C. 1033, 1049-50 (1979), *rev'd on other grounds*, 698 F.2d 1229 (9th Cir. 1982), *cert. denied*, 464 U.S. 816 (1983).

equivalent to cash, but rather because established accounting rules treated them as merely representative of whatever had been given to acquire them.[135] To hold that Zarin acquired basis in his chips equal to the amount of his debt and was therefore entitled to a loss upon the disposition of those chips would have been to reinstitute the rejected two-step approach.[136]

Additional timing rules also apply, however, for liabilities subject to § 165, which governs the deduction of losses, including gambling losses.[137] Regardless of whether a taxpayer uses the cash or accrual method, such losses are taken into account only when "actually sustained."[138] Does a taxpayer "actually sustain" a loss when he or she loses a chip representing an unenforceable and ultimately disputed debt? Concluding that Zarin had sustained his gambling losses in 1980, the Tax Court majority answered this question in the affirmative.[139] It necessarily held that incurring an unenforceable and disputed debt constitutes the sustaining of a loss sufficient to permit a deduction under § 165, if such loss is otherwise deductible under that section.[140]

This was a remarkable holding. Prior law had held that even the actual *payment* of an unenforceable debt could not constitute the sustaining of a loss within the meaning of § 165.[141] The *Zarin* Tax Court majority implied that merely *incurring* such a debt was sufficient.[142]

What of the fact that Zarin's debt was disputed? The deduction of losses represented by disputed debt had previously been governed by *N. Sobel, Inc. v. Commissioner*, the case that also established the disputed debt exception to the discharge of indebtedness doctrine.[143] The taxpayer in that case had purchased stock, giving its seller a note for $21,700.[144] The following year, the taxpayer sued the seller for rescission, alleging among other things that the note violated state law.[145] The seller's successor-in-interest countersued for the principal amount of the note plus interest.[146] Three years later, the parties settled and the taxpayer paid the seller $10,850, which it deducted on its federal income tax return.[147] The IRS disallowed the loss, asserting that the stock had become worthless in an earlier year—in other words, that the taxpayer had sustained the loss prior to the settlement.[148] In addition, the IRS asserted

135. Zarin v. Comm'r, 92 T.C. 1084, 1100 (1989), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990).
136. *See id.*
137. I.R.C. § 165.
138. Treas. Reg. § 1.65-1(a) (as amended in 1977).
139. *Zarin*, 92 T.C. at 1096.
140. I.R.C. § 165.
141. *See supra* note 109.
142. *Zarin*, 92 T.C. at 1099-100.
143. N. Sobel, Inc. v. Comm'r, 40 B.T.A. 1263, 1264 (1939).
144. *Id.*
145. *Id.*
146. *Id.*
147. *Id.*
148. *Id.* at 1264-65.

that the taxpayer recognized discharge of indebtedness income equal to the difference between the face amount of the note and the settlement amount.[149] The Board of Tax Appeals disagreed, holding that the settlement established both (1) the timing and amount of the loss for loss purposes and (2) the amount of the debt for debt discharge purposes.[150] In effect, *N. Sobel* can be read as acknowledging the need for consistency between the loss recognition and discharge of indebtedness rules.

The *Zarin* Tax Court majority apparently overruled the first aspect of *N. Sobel* by impliedly holding that a taxpayer whose loss is represented by a disputed debt—a debt on which the taxpayer continues to deny liability—is entitled to claim that loss notwithstanding the dispute. It also limited the second holding of *N. Sobel*—that the settlement of a disputed debt representing a claimed loss merely establishes the amount of both the loss and the debt—to "unliquidated" debts.[151]

Both aspects of the majority's treatment of *N. Sobel* were puzzling. Its holding that a taxpayer whose loss is represented by a disputed debt is nevertheless entitled to claim that loss may have disadvantaged Zarin; in general, however, it is extraordinarily taxpayer-favorable. Its holding that the disputed debt exception to the debt discharge doctrine was limited to liquidated debts was flatly inconsistent with the facts of *N. Sobel*: the taxpayer in that case had executed a note in a fixed amount, the holder sued on the note, and the parties settled.[152] In sum, in its zeal to find some way to tax the consumption value of Zarin's gambling, the Tax Court majority rode roughshod over major structural elements of both cash and accrual accounting—with potentially far-reaching implications.

Finally, the majority's treatment of § 108(e)(5), the statutory purchase price adjustment exception, was both troubling and unnecessary. Application of § 108(e)(5) to a purchase of chips requires use of the rejected two-step approach to casino accounting. In other words, it requires that the purchase of chips be accorded independent tax significance. Given the court's prior uniform rejection of the two-step approach, the majority might simply have held § 108(e)(5) inapplicable on the ground there was no tax-cognizable purchase of chips.[153]

Elements of the opinion can be read as consistent with such a holding. The majority also, however, made an unfortunate attempt to demonstrate that chips were not "property" within the meaning of the statute.[154] The parties, of course, had stipulated that chips *were* property, and the Tax Court rules specifically authorized stipulation of the application of law to

149. *Id.* at 1265.

150. *Id.*

151. At least one subsequent case appears to have adopted the *Zarin* Tax Court majority's analysis in this regard. *See* Preslar v. Comm'r, 167 F.3d 1323, 1328 (10th Cir. 1999) (finding that "[t]o implicate the contested liability doctrine, the original amount of the debt must be unliquidated").

152. *Compare* Zarin v. Comm'r, 92 T.C. 1084, 1095-96 (1989), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990), *with N. Sobel*, 40 B.T.A. at 1264-65.

153. *See* I.R.C. § 108(e)(5) (1980).

154. *See Zarin*, 92 T.C. at 1098.

facts.[155] Apart from the stipulation, as matter of New Jersey law chips represent unsecured demand debt of the casino; in other contexts, such debt is normally treated as "property."[156] In dissent, Judge Ruwe's technical critique of the majority's analysis on this issue was scathing and to the point.[157]

Ironically, the majority's struggle with the issue was also largely irrelevant to future discharge-of-gambling-debt cases.[158] At the trial court level, Zarin had not argued the *nonstatutory* purchase price adjustment exception, and the court therefore had no reason to address it.[159] 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."

How, then, should we evaluate the Tax Court majority's opinion? I want to emphasize again that I have not yet addressed whether the court correctly measured Zarin's income as a matter of theory—in other words, whether the court was "right." My focus has rather been on the court's treatment of rules and precedent. Clearly, the court was not merely applying rules to facts nor was it merely answering open questions. In its zeal to tax Zarin's perceived consumption value, I suggest, the majority was a bull in a china shop, breaking rules wherever it turned.

2. *Tannenwald's Dissent*

Judge Tannenwald was troubled by the majority's bottom line, and particularly by "the incongruous result that the more a gambler loses, the greater his pleasure and the larger the increase in his wealth."[160] Appealing to common sense, he disagreed with the majority's assertion that Zarin had received consumption value of $3,435,000.[161] This factual conclusion was key to his analysis because it eliminated the theoretical pressure to find income.[162] This, in turn, eliminated the need for new law; Tannenwald could rely on the traditional rule that debt must be enforceable to be "debt" and on a simple interpretation of the disputed debt ex-

155. *Id.* at 1097.

156. N.J. ADMIN. CODE § 19:46-1.5(f) (2003) (providing that "each gaming chips is solely as evidence of a debt that the issuing casino license owes the person legally in possession of the gaming chips").

157. *See Zarin*, 92 T.C. at 1107 (Ruwe, J., dissenting).

158. The nonstatutory exception requires an examination of the cause of the discharge, while the statutory exception does not. The majority's "property" analysis might, therefore, make a difference where cause is an issue.

159. *See generally Zarin*, 92 T.C. 1084.

160. *Id.* at 1101 (Tannenwald, J., dissenting).

161. *Id.*

162. *Id.*

ception to justify his conclusion that Zarin did not recognize discharge of indebtedness income in 1981.[163]

Tannenwald's analysis can be criticized as technically inadequate. It is true that he did not offer a sophisticated technical resolution of any of the difficult issues the case raised, but this may have been intentional. His approach would have disposed of a very odd case without creating any significant new precedent. What likely motivated Tannenwald was neither a mechanical respect for old cases nor an ignorance of theory. It was more likely a jurisprudential concern—a judgment that this was simply the wrong case in which to make new law. He was right.

3. *Jacobs's Dissent*

Courts are usually reluctant to proceed on a theory that has not been raised or briefed by the parties. There are good reasons for this, as Judge Jacobs' dissent illustrates.[164] Jacobs was equally disturbed by the majority's bottom line, but chose a more innovative technique for avoiding it.[165] Since Zarin's debt was void *ab initio*, he reasoned, Zarin must have recognized income in 1980 to the extent of the value of the chips received—$3,435,000.[166] This income, he argued, should be treated as gain from wagering transactions within the meaning of § 165(d); as a result, Zarin should be allowed to deduct his $3,435,000 of losses against that income.[167] Jacobs seemed to assume, although he did not state so explicitly, that the result would be to avoid taxing the transaction altogether.[168]

There were many problems with Jacobs' approach, problems that would likely have been identified had the issues been briefed. First, his approach was flatly inconsistent with governing Supreme Court case law. In *James v. United States*, the Court held that 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."[169] This rule applied regardless of whether the obligation was legally enforceable.[170] Zarin, of course, was stipulated to have recognized an obligation to repay. Additionally, there was no reason to believe that *James* was obsolete.

Second, Jacobs' proposed rule was unadministrable. Whether a debt is "void *ab initio*" is often not determined until long after it is incurred. One can readily imagine a conscientious taxpayer who fails to report income in Year 1, believing that he has incurred enforceable debt on a

163. *See id.*
164. *See id.* at 1105 (Jacobs, J. dissenting).
165. *See id.*
166. *Id.*
167. *Id.*
168. *See id.*
169. James v. United States, 366 U.S. 213, 219 (1961).
170. *See* Liddy v. Comm'r, 808 F.2d 312, 314 (4th Cir. 1986) (stating that "[o]nly if the taxpayer can show that he has no claim of right by reason of a requirement to make prompt payments of amounts received even if such payments are made in the absence of an enforceable obligation . . . is the receipt of monies not deemed gross income").

purchase. Some years later, he learns that the debt was void from the outset. He is under no obligation to file an amended return for Year 1;[171] indeed, he may be prohibited from doing so. The result is that he is never taxed. Worse, Jacobs' proposed approach was not limited, in theory, to gambling debt. It appeared to apply any time a debt incurred for any purpose was subsequently determined to have been void from the outset.

Third, Jacobs' approach would have applied far more broadly, even in the casino gambling context, than Jacobs appeared to recognize. In 1981, casino gambling debts were generally enforceable in New Jersey.[172] Zarin's was an exception.[173] In Nevada, however, gambling debts were generally unenforceable as a matter of law.[174] Under Jacobs's approach, any gambler obtaining chips on credit in Nevada would apparently have been required to report income at the moment he acquired the chips—a very peculiar result. If he then subsequently lost those chips at gambling, the loss could be used against such "chip income," but only if it were incurred in the same year.

Finally, the approach would not have produced the bottom-line result Jacobs expected. Zarin probably received over $100 million of chips in exchange for unenforceable debt in 1980 alone.[175] His gambling losses, moreover, were clearly preference items for AMT purposes to the extent they exceeded sixty percent of adjusted gross income.[176] For AMT purposes, therefore, such losses would not fully have offset the "chip income" Jacobs believed Zarin had recognized. The net effect would have been a massive AMT tax liability.

4. *Ruwe's dissent*

Judge Ruwe, writing for himself and four others, treated the problem as one of simple statutory exegesis, concluding that Zarin's debt discharge income was exempt under § 108(e)(5), the statutory purchase price adjustment exception.[177] He began by observing that the factual

171. In general, taxpayers are not required to file amended returns, even if they discover that their original returns were incorrect.

172. The general New Jersey prohibition against the enforcement of gambling debts, N.J. Stat. Ann. 2A:40-3, was made inapplicable to casino debts by N.J. Stat. Ann. 5:12-124. *See, e.g.*, Gottlob v. Lopez, 501 A.2d 176 (N.J. Super. Ct. App. Div. 1985),

173. The extension of credit by New Jersey casinos "to enable any person to take part in gaming . . . activity as a player" is permitted by limited. *See* N.J. Stat. Ann. 5:12-101(a)(1) (West 2006). Gambling credit extended in excess of the amount under Casino Control Commission regulations is void *ab initio*. *See* Resorts Int'l Hotel, Inc. v. Salomone, 429 A.2d 1078 (N.J. Super. Ct. App. Div. 1981).

174. *See, e.g.*, Weisbrod v. Fremont Hotel, 326 P.2d 1104 (Nev. 1958); Milliken v. Sloat, 1 Nev. 573 (1865). This rule was amended in 1983 through the enactment of Nev. Rev. Stat. §§ 463.361-.366, which now permit enforcement of (1) gambling debts owed to licensed casinos and evidenced by "credit instruments," and (2) gambling debts owed by licensed casinos to their patrons, regardless of whether so evidenced. Nev. Rev. Stat. Ann. §§ 463.361-.366 (West 2006).

175. *See supra* note 45.

176. *See supra* note 44.

177. Zarin v. Comm'r, 92 T.C. 1084, 1107 (1989) (Ruwe, J., dissenting), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990).

predicates for the application of that statute had been stipulated by the parties: "The parties stipulated that 'CHIPS ARE PROPERTY which are not negotiable.' . . . In their briefs, both parties requested that the Court find this as a fact. Despite this, the majority fails to adopt this stipulated fact which is critical to the resolution of this case."[178]

In addition, he argued, chips were encompassed by the plain language of the statute, which should govern in the absence of "a clearly expressed legislative intent to the contrary."[179] In *Dickman v. Commissioner*, the Supreme Court held that, unless legislative qualifications or restrictions were imposed, the term "property" should be given "its broadest and most comprehensive sense."[180] "In this particular instance," Ruwe noted, "neither the statute nor the accompanying legislative history qualify or restrict the term 'property.'"[181] "Property" normally includes chips and the debt they represent; therefore, he concluded, it should be so construed in this context as well.[182]

Furthermore, the very purpose of the statute was "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."[183] Here, Ruwe noted, one of the principal factual issues was the value of what Zarin had received—the precise issue that § 108(e)(5) was supposed to eliminate.[184]

In addition to being contrary to the parties' Stipulation, contrary to the plain language of the provision, and contrary to its purpose, Ruwe argued, the majority's construction created no clear rule for future application of the statute.[185] While suggesting that § 108(e)(5) only applied to "normal commercial property," the majority failed to define that term.[186] While suggesting that § 108(e)(5) "may apply to some kinds of intangibles," but apparently not others, and asserting that "[a]bstract concepts of property are not useful" in deciding what property is within the contemplation of the section, the majority "leaves us to wonder what kinds of intangible property might come within the contemplation of the statute or what concepts, abstract or otherwise, were relied upon in construing the meaning of the statute."[187]

In conclusion, he stated:

> 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. The result produced is ironic for both the

178. *Id.*
179. *Id.*
180. Dickman v. Comm'r, 465 U.S. 330, 334-36 (1984).
181. *Zarin*, 92 T.C. at 1111 (Ruwe, J., dissenting).
182. *Id.* at 1107.
183. *Id.* at 1112 (quoting S. Rep. No. 96-1035, at 16 (1980)).
184. *Id.* at 1112-13.
185. *Id.* at 1108.
186. *Id.*
187. *Id.* at 1110.

> Court and petitioner. The Court must decide the difficult factual issues that § 108(e)(5) was intended to eliminate while petitioner incurs a huge tax liability, the magnitude of which is in direct proportion to his losses.[188]

Ruwe's analysis was persuasive in all but three respects. First, it placed ordinary canons of statutory interpretation above tax theoretical definitions of "income"—a hierarchy the majority was unwilling to accept. Second, it necessarily relied on a two-step approach to casino chip accounting; it treated the "purchase" of chips as an event having independent tax significance. This, as I have noted, was contrary to existing law. Third, it applied § 108(e)(5) even though Zarin no longer owned the chips at the time of the settlement. To fully appreciate why this might be inappropriate, some understanding of the theory behind the purchase price adjustment exception itself is necessary.

The purchase price adjustment exceptions are not really exceptions; they are deferral provisions. Assume, for example, that a taxpayer purchases a house in exchange for a $100,000 purchase money mortgage. Thereafter, the taxpayer and seller negotiate a reduction of the mortgage to $80,000. Whether the nonstatutory purchase price adjustment exception is available will depend on the reason for the adjustment; if the adjustment is really an adjustment to price, it should apply; if not, the taxpayer will generally realize discharge of indebtedness income. The reasons for a debt adjustment can sometimes be very difficult to prove. Section 108(e)(5), in effect, offers a safe harbor; a taxpayer whose discharge falls within the statutory confines need not prove the reason for the discharge. Under either exception, however, the consequence is an adjustment in the basis of the property. In our example, the taxpayer will now take the house with a basis of $80,000, rather than $100,000. If she then sells the house for $105,000, she will recognize $25,000 of gain rather than $5,000. In other words, the $20,000 that she would otherwise have recognized at the moment of discharge is now recognized on sale; it has been deferred.

This deferral mechanism 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 over time. 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

188. *Id.* at 1115-16.

fact out of pocket only $500,000. In other words, Ruwe would have mismeasured Zarin's income.

5. The Motion for Reconsideration

After losing in the Tax Court, Zarin changed counsel. His new counsel moved for reconsideration, primarily on the ground that Zarin was insolvent both before and after the discharge. The IRS had made no effort to prove solvency. Since the burden of proof rested on the IRS, Zarin now argued, the court should have found that Zarin was exempt under the insolvency exception of § 108(a). In further support of his motion, Zarin filed affidavits and balance sheets as of May 31, 1981, and December 31, 1981—that is, before and after the discharge.[189] Both balance sheets showed liabilities (excluding Resorts' claim) in excess of his assets. Chief Judge Nims, who had voted with the majority on the case-in-chief, held that (1) insolvency was an affirmative defense, on which the burden of proof rested with Zarin, (2) Zarin, through his original counsel, had conceded the issue in brief, and (3) the balance sheets were of questionable accuracy. He therefore denied the motion. Zarin changed counsel again, retaining the firm in which I was a partner.

6. The Third Circuit Decision

On Zarin's behalf, we filed a notice of appeal with respect to 1981; the IRS failed to file a cross-appeal with respect to 1980, and 1980 therefore closed. For the first time, Zarin could argue 1981 with some assurance that the IRS would not be able to argue in the alternative that he had recognized income in 1980.[190]

Our analysis of prior tax decisions of members of the Third Circuit panel assigned to the case suggested that Judges Cowen and Weis were inclined to be pro-taxpayer and were partial to plain language arguments. It also suggested that Judge Stapleton tended to vote for the government in tax cases and was more of a theoretician. Our briefs therefore empha-

189. *See supra* notes 76-77 and accompanying text.

190. In its brief to the Third Circuit, the IRS stated: "[i]n the Tax Court, the Commissioner abandoned the position that taxpayer had income in 1980 from larceny." Brief for the Appellee, at 6, Zarin v. Comm'r, 916 F.2d 110 (3d Cir. 1990) (No. 90-1240). In the closing minutes of oral argument, however, IRS counsel argued for the first time that if the court concluded income should have been reported in 1980 rather than 1981, it should remand the case to the Tax Court for application of the mitigation provisions of I.R.C. §§ 1311-1315. *See* Transcript of Oral Argument at 37-38, *Zarin*, 916 F.2d 110 (No. 90-1240). Neither party had briefed either the mitigation issue or any substantive issue relating to 1980. In the absence of briefing, the Third Circuit majority—clearly bewildered—dealt with the problem with its incomprehensible footnote 12:

> The Commissioner argues in the alternative that Zarin recognized $3,435,000 of income in 1980. This claim has no merit. Recognition of income would depend upon a finding that Zarin did not have cancellation of indebtedness income solely because his debt was unenforceable. We do not so hold. Although unenforceability is a factor in our analysis, our decision ultimately hinges upon the determination that the "disputed debt" rule applied, or alternatively, that chips are not property within the meaning of I.R.C. § 108.

Zarin, 916 F.2d at 119.

sized the human aspects of the case and framed Zarin's doctrinal arguments, as much as possible, in plain language terms, only subsidiarily exploring the technical accounting problems raised by the Tax Court's opinion and the theoretical considerations discussed in Part II of this Article. When the decision came down, our predictions proved correct: Judges Cowen and Weis voted for taxpayer, Judge Stapleton for the government.[191]

Judge Tannenwald's dissent, I have suggested, was probably the most jurisprudentially prudent of the Tax Court opinions. In 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. Yet, the Third Circuit's opinion probably commands the least respect of any of the *Zarin* opinions, at least within the tax community. Why?

Law is not merely the bottom line. Judge Aldisert, who has written widely on the art of opinion-writing, has noted that: "the court's ability to develop case law finds legitimacy only because the decision is accompanied by a publicly recorded statement of reasons."[192] The selection of material facts is part of that statement; so is the selection of authority deemed relevant—whether or not that authority is followed.

Before the Third Circuit, Zarin cited extensive case law to the effect that debt must be enforceable to be "debt" for tax purposes, concluding with the observation that "Congress itself has adopted the rule in I.R.C. § 108."[193] Judge Cowen, writing for the majority, ignored this case law, seizing instead on the referenced language of § 108(d)(1)stating that, "[f]or purposes of this section, 'indebtedness of the taxpayer" means any indebtedness (A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property."[194] Because Zarin's debt was unenforceable, he reasoned, it was not debt "for which the taxpayer is liable."[195] He then considered at length whether Zarin's debt was debt "subject to which [the taxpayer holds] property"—specifically, whether the chips were property subject to his debt to Resorts—a question that had not been briefed by either party.[196] Adopting the Tax Court's § 108(e)(5) reasoning, he concluded that chips were not "property" within the meaning of § 108(d)(1)(B) because they constituted "nothing more than an accounting mechanism."[197] He therefore held that Zarin's debt was not debt for debt discharge purposes.[198] In effect, he adopted Judge Tannenwald's conclusion that unenforceable debt was not debt, but framed his

191. Judge Stapleton effectively adopted most of the Tax Court majority's arguments. *See Zarin*, 916 F.2d at 117 (Stapleton, J., dissenting).
192. Ruggero J. Aldisert, Opinion Writing 9 (1990).
193. Brief of Appellant at 26, *Zarin*, 916 F.2d 110 (No. 90-1240).
194. *Zarin*, 916 F.2d at 113.
195. *Id.*
196. *Id.*
197. *Id.* at 114.
198. *Id.* at 117.

holding entirely in statutory terms.[199]

Judge Cowen also adopted Judge Tannenwald's second rationale—that the debt was exempt because it was disputed. He found *United States v. Hall*[200] and *N. Sobel, Inc. v. Commissioner*[201] indistinguishable.[202] Like Judge Tannenwald, Judge Cowen seemed inclined to follow precedent, however arguably defective, at least given the equities of the case.[203] It was in the context of the disputed debt exception, however, that Judge Cowen made his most controversial pronouncement. Explaining that exception, he offered his own illustration, again not taken from any of the briefs:

> 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 $7000 in full satisfaction of the debt, the transaction would be treated as if the initial loan was $7000. When the taxpayer tenders the $7000 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.[204]

All well-trained tax lawyers know that this explanation is "wrong"; I will discuss why in Part II.A below. The effect of the explanation, therefore, was to destroy the credibility of what might otherwise have been a plausible opinion.

Two observations about Judge Cowen's approach to the disputed debt issue may be useful. First, it was completely consistent with his "plain language" approach to the case as a whole. Having accepted that a dis-

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199. Professor Shaviro has criticized Judge Cowen's decision on two grounds: (1) that §108 is not necessarily co-extensive with the general debt discharge rule, and (2) that the burden was on Zarin to show that the receipt was excludible. *See generally* Shaviro, *The Man Who Lost Too Much:* Zarin v. Commissioner *and the Measurement of Taxable Consumption*, *supra* note 23. Shaviro's arguments are not well-founded. The 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. As has been noted, *see supra* note 88 and accompanying text, I.R.C. § 61(a)(12) was apparently added only for purposes of completeness and has never previously been construed as having independent substantive effect. To 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). Shaviro's second argument, that Zarin has the burden of showing that the receipt was excludible, ignores the fact that the burden issue was decided against the IRS in the Tax Court, *see* Zarin v. Comm'r, 92 T.C. 1084, 1088, *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990), and was conceded by the IRS before the Third Circuit, *see* Brief for the Appellee at 24-25, *Zarin*, 916 F.2d 110 (No. 90-1240).

There was, nevertheless, a simple construction of I.R.C. § 108(d)(1) that would have allowed it to encompass unenforceable debt: that § (A) referred to personal debt, and § (B) to secured debt. I.R.C. § 108(d)(1)(A)-(B) (1980). The IRS neglected to make this argument.

200. 307 F.2d 238 (10th Cir. 1962).

201. 40 B.T.A. 1263 (1939).

202. *Zarin*, 916 F.2d at 115.

203. *Id.*

204. *Id.*

puted debt exception was required by precedent, he then simply interpreted it in accordance with its plain language meaning, not by reference to theory. There was a bona fide dispute, therefore the exception applied. Second, the disputed debt rationale may have spoken with particular force to Judge Cowen because of his prior connection with the issues involved. Prior to his elevation to the Third Circuit, Judge Cowen had served as magistrate in the United States District Court for the District of New Jersey.[205] In that capacity, he had presided over *Zarin v. Resorts International Hotel, Inc.*,[206] one of the two substantive cases in which the underlying controversy had been litigated. Judge Cowen knew for a fact that the debt was disputed.

II. WAYS OF THINKING ABOUT WHAT HAPPENED: A THEORIST'S ACCOUNT

Practitioners live in a world of precedent and authority, scholars at least partially in a world of theory. The relationship between the two is sometimes uneasy, as the foregoing discussion of the *Zarin* opinions illustrates. We turn now to the problem of theory and the question beloved of scholars: who was "right"? Several theoretical tools are commonly used in construing the Internal Revenue Code. These are not "rules" in the ordinary sense—not statutes or explicit rules of decision. Yet they affect the course of tax litigation and interpretation more profoundly than many more explicit rules, and *Zarin* implicates them all.

A. Complete Accounting

The first "rule" can be thought of as an interpretive principle: in general the Code should be construed, if possible, so that a taxpayer's reportable income, taking into account all relevant years, will ultimately equal her real income.[207] This principle has never been recognized as such by any court and has no commonly accepted name. I have elsewhere called it the "principle of complete accounting," since it focuses on the need to account *completely* for taxpayer's income rather than on other aspects of accurate measurement.[208] For convenience, I will use the same term here. Complete accounting does not mean we should ignore the rule that income is to be computed annually. What it does mean is that the various rules we apply annually should be structured and construed to work together to measure tax base income *completely* over time—not to leave anything out and not to count anything twice.

The principle of complete accounting is intuitive to most tax professionals and has a powerful normative appeal. Decisions that flout the principle without compelling statutory authorization are viewed as

205. Almanac of the Federal Judiciary 30 (Megan Rosen ed., Aspen Publishers 2006) (1984).
206. Civil Action No. 80-3972 (D.N.J. 1980).
207. By "real income," I mean such income as Congress has included in the tax base.
208. *See* Seto, *supra* note 26, at 227-34.

"wrong." Even statutes that flout the principle are viewed with suspicion. Courts will often ignore precedent and sometimes even the plain language of the Code to ensure complete accounting.[209]

This is why tax professionals view Judge Cowen's illustration of the disputed debt exception as obviously incorrect. Recall that in his example, a taxpayer borrows $10,000, refuses in good faith to pay it back, and settles with the lender by paying back only $7,000. On these facts, Judge Cowen suggested, the taxpayer will not recognize any income upon the discharge. In reality, of course, our hypothetical taxpayer is $3,000 wealthier. The principle of complete accounting requires that at some point the taxpayer be charged with $3,000 of income, so that his reportable income will ultimately equal his real income. Otherwise, our accounting of his transactions will be incomplete; we will have failed to account for $3,000 of income. If the taxpayer is not required to report income when he takes out the loan, then he must be required to report it when he settles the debt. In the case of a cash loan this is true regardless of whether the debt is disputed, Judge Cowen's dictum to the contrary notwithstanding.

Indeed, the principle of complete accounting requires this conclusion even if the debt is unenforceable. So long as the taxpayer is not required to report any income when he takes out the loan, complete accounting requires the recognition of $3,000 at some point—the only obvious possibility being the moment of discharge. This, in turn, explains why the Tax Court majority was willing to do violence to so much existing law. Having concluded that Zarin had received $2,945,000 in consumption value for which he had not paid, it felt compelled to find a way to construe the available rules to account for that income completely.

The same principle explains why Judge Tannenwald had to disagree with the Tax Court majority's conclusions with regard to value before he could rely on existing precedent to dispose of the case. Had he agreed with the majority's value analysis, he too would probably have felt compelled to find a way to tax that value.

It also explains why Judge Ruwe was "wrong." Complete accounting requires that any purchase price adjustment exception normally be limited to cases in which the taxpayer has sufficient remaining basis in the purchased property to absorb the entire adjustment.[210] Any other construction of those exceptions is likely to result in the mismeasurement of the taxpayer's income over time. And this, in turn, suggests that the courts could not properly have accepted Zarin's nonstatutory purchase price adjustment argument either.

209. *See id.*
210. *See id.* at 271.

B. Haig-Simons Income

But what is income? What is it that we are to account for under the principle of complete accounting? A second tool commonly used to make sense of the Code is the so-called "Haig-Simons" definition of income, which states that a taxpayer's income equals (1) his or her change in net worth plus (2) his or her consumption.[211] The Haig-Simons definition explains many of the most important structural features of the Code. Some examples, focusing on aspects of the theory particularly relevant to the *Zarin* problem, may be useful.[212]

Example 1: Taxpayer receives value and does not lose or consume it. Her net worth therefore increases. The Haig-Simons definition says she should have income, and § 61 of the Code so provides by requiring her to report gross income.

Example 2: Taxpayer receives value and consumes it. Her net worth therefore remains the same, but she has consumption. Haig-Simons says she should have income. The Code accomplishes this in two ways: first, by making the receipt of consumption taxable, and second, by making consumption expenditures nondeductible. Under § 61, Haig-Simons suggests, gross income includes the unpaid-for receipt of consumption value; § 262 denies deductions for personal expenditures that are paid for.

Example 3: Taxpayer spends value for the purpose of producing future income. Her net worth therefore decreases. She has no consumption, because by consumption the Haig-Simons definition means personal use, not business use or use in a for-profit activity. Theory, therefore, says she should have a deduction, and the Code so provides. Section 162 authorizes a deduction for trade or business expenses and § 212 provides a deduction for the costs of producing income.

I have argued elsewhere that the principle of complete accounting applied to a Haig-Simons definition of income explains most of the essential features of the discharge of indebtedness doctrine.[213] I focus here on its implications for the discharge of two kinds of debt particularly relevant to the *Zarin* problem: (1) debt incurred to pay for deductible costs of producing income, and (2) debt incurred to pay for current consumption.

If a taxpayer incurs but does not pay debt to pay for *deductible costs of producing income*, whether a discharge of that debt is taxable should depend on whether she was allowed a deduction when she incurred the debt in the first place. Taking into account the entire sequence of transactions, she has experienced neither an increase in net worth nor any consump-

211. *See* Henry C. Simons, Personal Income Taxation 50 (1938); Robert M. Haig, *The Concept of Income—Economic and Legal Aspects*, *in* The Federal Income Tax 1, 7 (Robert M. Haig ed., 1921). For a summary of the economic literature on the definition of income, see Graetz & Schenk, *supra* note 24, at 106-07. *See also* Victor Thuronyi, *The Concept of Income*, 46 Tax L. Rev. 45, 46 (1990).

212. For a more expansive discussion of how Haig-Simons explains important features of the Code, see generally Theodore P. Seto & Sande L. Buhai, *Tax and Disability: Ability to Pay and the Taxation of Difference*, 154 U. Pa. L. Rev. 1053 (2006).

213. *See* Seto, *supra* note 26, at 237-38.

tion. Complete accounting should therefore result in no net taxable income or loss, taking all tax consequences into account. If the taxpayer was allowed a deduction when she incurred the debt (as she normally would be if she were an accrual method taxpayer), complete accounting requires that she recognize income when the debt is discharged without payment. The taxable discharge in effect reverses the earlier deduction. The tax matches Haig-Simons income, and the principle of complete accounting has been satisfied. If, on the other hand, the taxpayer has not been allowed a deduction when she incurred the debt (as would normally be the case if she were a cash method taxpayer), there is no deduction to reverse and no real income to account for. The principle of complete accounting therefore implies that she should have no debt discharge income at all.[214]

By contrast, if a taxpayer pays for *current consumption*—for example, a catered personal party—by incurring debt, the principle of complete accounting applied to a Haig-Simons definition of income implies that a discharge of that debt must result in income regardless of her accounting method. The taxpayer has received consumption value without paying for it; at some point, she must be required to report a corresponding amount of income.

The Tax Court majority's opinion was based on the conclusion that Zarin had received $2,935,000 of taxable consumption without paying for it. Consistent with the Haig-Simons definition, therefore, it bent existing law to require Zarin to report that amount as income upon the discharge.

The key assumption underlying the majority's theoretical analysis was, therefore, that gambling should be treated as consumption rather than as an income-producing activity. Although none of the *Zarin* opinions discuss this issue, the issue is far more difficult than it might at first appear. Many economic activities involve both an element of pleasure and a potential for the production of income. Speculating in currency futures and playing craps, for example, are similarly ambiguous in this regard: though the average participant loses, there is nevertheless some potential for the production of income—indeed, that is primarily what draws participants to both activities—and there is a thrill involved in each.

We might determine whether currency futures trading and gambling are consumption or income-producing activities on a case-by-case basis. The Supreme Court in *Commissioner v. Groetzinger*, for example, held that whether a gambler was engaged in a trade or business should be determined separately for each taxpayer.[215] Thus, we might inquire into the particulars of Zarin's motives and behavior. If we conclude that he was primarily having fun we would tax him on his debt discharge. If, on

214. An illustration of this principle appears in *Crane v. Commissioner*, 331 U.S. 1, 4-5 (1947), where the IRS apparently conceded that Mrs. Crane's "debt" should not be treated as including her valid state law debt for accrued but unpaid interest—presumably because, as a cash method taxpayer, she had not yet been allowed to take that interest into account for deduction purposes.

215. Comm'r v. Groetzinger, 480 U.S. 23, 36 (1987).

the other hand, we conclude that he was primarily in it for the money (and, of course, that under applicable accounting rules he should not be allowed a deduction merely by reason of incurring the debt), we would treat his discharge as nontaxable.

There are at least two problems with a case-by-case approach. First, it is extremely difficult to administer. Note that the Haig-Simons question is not whether the activity constitutes a trade or business (the *Groetzinger* question), but merely whether the activity is engaged in for profit—whether, in the language of the § 183 regulations, "the taxpayer entered into the activity, or continued the activity, with the objective of making a profit."[216] Some gamblers may expect to lose and gamble just to have fun, but most, however irrationally, hope to beat the odds and make money.[217] Many do. *Groetzinger* to the contrary notwithstanding, a debt discharge rule that turns on the expectations and intentions of each gambler either will not work or will always lead to a conclusion that the gambler hoped to make money. Second, a case-by-case approach is inconsistent with the way the Code treats gambling generally. In general, the Code taxes gamblers the same way regardless of their motives, just as it taxes currency futures traders consistently regardless of their motives. In other words, Congress has arguably categorized these activities by statute.

An alternative approach, therefore, might be to examine the structure of the Code itself to see whether gambling is treated *per se* as a consumption or income-producing activity. Unfortunately, the answer is ambiguous.[218] Gambling winners are taxed as if they were engaged in an income-producing activity—that is, they are taxed solely on their increase in net worth, not on their increase in net worth plus the consumption value of their gambling. Net gambling losses, however, are not deductible. This might suggest a congressional decision to treat net gambling losses, in effect, as the costs of consumption. Alternatively, we might view the gambling loss limitation rules simply as another example of basketing; prohibiting the use of one kind of losses to offset other types of income. Under this latter view, Judge Jacobs' proposal to treat Zarin's debt discharge income as within the gambling basket would be consistent with the purpose of the statute.

Some have suggested that the Code's ambiguous treatment of gambling reflects an outdated moral disapproval of the activity itself.[219] This may

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216. Treas. Reg. § 1.183-2(a) (1972).

217. As the Tax Court stated in *Collins v. Commissioner*, 64 T.C.M. (CCH) 557, 563 (1992):

> The opportunity to win money is not the only reason a betting ticket is valuable, but it is the overwhelming motivation for most gamblers. The different kinds of excitement associated with gambling are inextricably bound to the possibility of winning money. Gambling is not very interesting without the opportunity to win or lose something of value.

218. *See* Zorn, *supra* note 23, at 5-10 (giving an overview of current tax rules applicable to gambling).

219. *See, e.g.*, *id.* at 2-3.

be true. Even assuming that we can find our way past the moral issues, however, the more fundamental conceptual problem remains: it is extremely difficult to separate out the pleasurable and income-producing aspects of gambling.[220] Like § 274(n), which limits the deduction of business meals, or § 183, which limits the deduction of hobby expenses, § 165(d) may simply acknowledge the impossibility of a clean and principled resolution of the issue.[221]

On its stipulated facts, *Zarin* does not present these ambiguities as sharply as it might. Were we to apply a *Groetzinger* analysis to the case, we might conclude that Zarin was engaged in consumption. Had Zarin not earlier faced a risk of criminal liability, however, his counsel might well have asserted a profit-making motive. *Collins v. Commissioner*, decided two years after *Zarin*, presented the issue much more starkly.[222] In *Collins*, a ticket seller at an off-track betting parlor in New York placed racing bets on his own behalf without paying for them. He was caught and pleaded guilty to grand larceny.[223] Consistent with precedent, the Tax Court held that he thereby recognized ordinary income from theft, and that his wagering losses could not be deducted against such income.[224] To bolster this perfectly adequate legal analysis, however, the court felt it necessary to invoke theory, holding as matter of law that gambling is a form of consumption.[225] Haig-Simons, it reasoned, therefore required that the pre-race value of the bets be included in taxpayer's income.[226]

Was Collins engaged in gambling as consumption or gambling as an income-producing activity? The *Collins* court, contrary to *Groetzinger*, appeared to hold that gambling was consumption *per se*. At the same time, it argued quite forcefully that the objective of most gamblers was to make money, a statement legally inconsistent with that holding. The parties in *Collins* had not stipulated that gambling was consumption; indeed, they had stipulated that the taxpayer acted as he did because he "would like some money."[227] The basis for the court's conclusion that Collins' gambling was consumption, therefore, was not clear. In the circumstances, its invocation of Haig-Simons muddied rather than cleared the waters. Ironically, *Collins* appears to have been the first United States tax case ever explicitly to invoke the Haig-Simons definition of income as a tool of decision.

220. Professor Zorn takes the position that gambling should be subject to the same tax rules as any other potentially income-producing activity. *See id.* at 53-54. His proposal ignores the practical inadministrability of any regime for the taxation of gambling that requires a factual determination of each gambler's motives.

221. *See* I.R.C. §§ 165(d), 183, 274(a) (West 2006).

222. *See generally Collins*, 64 T.C.M. (CCH) 557.

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.*

227. *Id.*

In general, we are left without a clear Haig-Simons answer to the question of whether a discharge of gambling debt should be income. Even if we are willing to conclude that generally, or in a particular case, gambling should be treated as consumption, we are also left with Judge Tannenwald's conundrum: how can it possibly make sense to hold that losers have more consumption value than winners; that the unluckiest gamblers should be taxed as though they had the most fun? To resolve this question, we turn to a less well-explored but equally important aspect of tax theory.

C. The Use of Markets to Measure and Define Income

Although Haig-Simons theorists sometimes speak of value and income in the abstract, the Internal Revenue Code relies on markets to measure both. The use of market value is objective and administrable, approximates subjective value so long as markets are efficient (and often even if they are not), and is generally consistent with lay notions of just taxation.

Even absent an actual arm's-length market transaction, the Code constructs a hypothetical market transaction to define value—the mythic willing seller and willing buyer acting without compulsion and with reasonable information.[228] That this definition is merely a stop-gap, however, normally to be applied only if we have no actual market transaction, is demonstrated by the fact that we almost never second-guess actual market transactions on the ground that a party acted under compulsion or lacked essential information. When the sign in the store says "Lost Lease, Must Sell," we do not treat the lucky buyers as recognizing income by reason of their bargain purchases even if we can demonstrate that the seller is acting under extreme duress.[229] Conversely, when a buyer pays more than he should for an item simply because he lacks basic and reasonably available information, we do not allow him to claim a loss. In our system, arm's-length markets almost always rule.

Some have suggested that compulsive behavior might properly be subject to a special set of tax rules.[230] Compulsive behavior, however, is merely one departure from the assumption of efficient markets that allows us to use actual market transactions to approximate subjective value. Were we to apply different valuation rules in cases of compulsive behavior, consistency would require that we apply different rules in other imperfect market situations as well—for example, in cases involving monopolistic pricing, positive externalities (including "psychic income"), or failures of information. This would dramatically increase the complexity of our tax system. As a practical matter, an administrable system simply cannot require its agents to determine whether a taxpayer was acting

228. *See supra* note 69 and accompanying text.

229. *See supra* note 70 and accompanying text.

230. *See, e.g.*, Shaviro, *The Man Who Lost Too Much*, *supra* note 23, at 236-39. *Contra* Barton, *supra* note 23, 773-75.

with "free will" or, on the contrary, was a compulsive gambler, cocaine addict, alcoholic, workaholic, or chocaholic.

A market-based approach to the measurement of income works fairly well for most transactions. There are two contexts, however, in which it works poorly or not at all.

First, the use of markets to measure income often does not work in cases involving unconventional transactions or pricing structures. In such cases, courts are more likely to look beyond pure market-based measurement. One well-known example is *Turner v. Commissioner*, in which a taxpayer won two non-transferable first-class steamship tickets from New York to Buenos Aires.[231] The retail price of the tickets was $2,220.[232] With an annual income of just $4,535, however, it was unlikely that taxpayer would have purchased the tickets in a conventional market transaction or, indeed, kept the tickets if he had been given the option of selling them.[233] In the circumstances, therefore, the court looked beyond market pricing in an attempt to assess directly the tickets' subjective value to the taxpayer.[234]

A casino is an unconventional market.[235] Patrons do not necessarily pay for what they get or get what they expected. Nevertheless, casinos are businesses and do provide services. The total price paid by gamblers collectively for such services equals their collective gambling losses (or the casinos' net gambling revenues) over the long term.[236] If casino gambling is consumption, therefore, the gamblers' collective losses represent the market value of such consumption. The problem is that casino pricing is collective, not individual. How much an individual gambler pays for his or her consumption value depends on whether he wins or loses. Only losers pay; winners get their consumption value for free.

In such a market, how should we assign consumption value among individual taxpayers for Haig-Simons purposes? One possibility would be to treat gambling as having, in effect, a per-bet consumption value.[237]

231. Turner v. Comm'r, 13 T.C.M. (CCH) 462 (1954).

232. *Id.*

233. *Id.*

234. *Id.*

235. This may explain in part why a disproportionate number of gambling cases appear in tax textbooks. *See, e.g.*, Comm'r v. Groetzinger, 480 U.S. 23, 24 (1987) (discussing whether parimutuel wagering can be a trade or business); United States v. Hughes Props., Inc., 476 U.S. 593, 595 (1986) (discussing whether amounts guaranteed for payment on progressive slot machines are deductible by accrual method taxpayers); Flamingo Resort, Inc. v. United States, 664 F.2d 1387, 1388 (9th Cir. 1982) (addressing whether receipt of unenforceable gambling debts meets the all events test for income recognition by an accrual method taxpayer); Olk v. United States, 536 F.2d 876, 876 (9th Cir. 1976) (discussing whether "tokes" given to a craps dealer are gifts).

236. *See* ABT ET AL., *supra* note 27, at 42. Casino gamblers' collective losses pay not only for the fun of gambling, but also for so-called "comps" and below-market prices for meals and lodging. Thus Professor Shaviro's suggestion that Zarin should have been subject to additional taxation on his comps is incorrect. *See* Shaviro, *The Man Who Lost Too Much*, *supra* note 23, at 235-36. Collectively, gamblers pay for everything they get. There is no such thing as a collective free lunch.

237. *See* Shaviro, *The Man Who Lost Too Much*, *supra* note 23, at 231-35.

Under such an approach, a gambler who places a particular bet would be deemed to have received the same consumption value regardless of whether he wins or loses. The measure of consumption value under such an approach would be expected cost. A gambling winner would be taxed on both his winnings and the expected cost of his bets. A gambling loser would be taxed on the same expected cost; he would be allowed a deduction for losses in excess of expected cost. Under such an approach, Zarin would be treated as having received $3.435 million of consumption value; over several hundred thousand roles of the dice, his actual losses probably very closely approximated his expected losses.

There are, however, at least three problems with such an approach. First, it is inconsistent with current law. Gambling winners are not currently taxed on expected cost; losers are not permitted to deduct loses in excess of expected cost. A Haig-Simons analysis that implies rules radically different from current law is of limited use in interpreting that law.

Second, such an approach would be unadministrable unless we are willing to accept actual net losses as a proxy for expected losses. To compute expected losses directly, we would need to keep track of every bet a gambler makes; in a casino, this is utterly impractical. The use of net losses as a proxy for expected losses is statistically defensible for high-volume gamblers in games strictly of chance. It is not statistically valid, however, for gamblers who place relatively few bets or gamblers who play games combining skill and chance, such as poker, blackjack, or pari-mutuel betting. A Haig-Simons analysis limited to certain gamblers and certain games is far less attractive than one applicable to gambling generally.

Finally and most importantly, the assumption of a fixed per-bet consumption value is unrealistic. We all know that it is more fun to win than to lose. Stated more theoretically, gamblers bet not merely for money, but for consumption value as well. If they win, they win both money and consumption value. If they lose, they lose money and are unhappy to boot. Judge Tannenwald's intuition that it makes no sense to hold that "the more a gambler loses, the greater his pleasure"[238] may therefore have support in pricing theory. The fact that Zarin "paid" $3,435,000 does not necessarily mean that he received an equivalent amount of consumption value. A part of that money went to paying for someone else's consumption value, someone who was luckier than he.

But if we believe it is more fun to win than to lose, then the Tax Court's Haig-Simons analysis was 180 degrees wrong. It would tax losers on nonexistent consumption value and exempt winners—who do receive consumption value—from taxation altogether. If we believe it is more fun to win than to lose, then there is no Haig-Simons reason to tax the discharge of any casino gambling debt at all, enforceable or unenforceable, disputed or admitted. By definition, the debtor is a loser. By definition,

238. Zarin v. Comm'r, 92 T.C. 1084, 1101 (1989) (Tannenwald, J., dissenting), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990).

therefore, he has little or no consumption value to tax.[239] This, in turn, would suggest that *United States v. Hall*, which appeared to hold that discharge of gambling debt was exempt *per se* from the debt discharge doctrine, was theoretically sound.[240]

A second situation in which a market-based approach to valuation does not work is when two market transactions arguably bear on the same value. A taxpayer makes an initial deal in a market transaction; subsequently, that deal is adjusted for reasons that bear on the fairness or appropriateness of the original transaction. I will call the latter "rescissionary" adjustments.

Rescissionary adjustments arise in a wide variety of situations. There may be disputes about the value of whatever was purchased. Consumer protection statutes may force an adjustment where legislatures worry that consumers are not being treated fairly. As a matter of good business practice, a seller may even make rescissionary adjustments when it is not legally obligated to do so. Assume, for example, that a taxpayer has purchased an airline ticket for $400 using a third party credit card to pay for the purchase. The airline subsequently lowers the relevant fare to $300 and, although not legally obligated to do so, refunds the difference to the taxpayer as a credit to his charge account. Intuitively, most of us would view this as a purchase price adjustment, not as income, even though the market at the time of the original purchase clearly supported the $400 price.[241]

There are at least two possible ways to determine whether an adjustment to debt is rescissionary. One way is to attempt an independent valuation of the merits of the original market price—looking, perhaps, at comparable goods and transactions in the same vicinity at about the same time. In many situations, however, this will not work. Perhaps, for example, in 1980, Resorts discounted the debts of *really* big spenders, but on an irregular and informal basis; it would be virtually impossible to use this information to determine one "true" value of what Zarin received. In our airline ticket hypothetical, an independent assessment of original value would conclude that the original value was in fact $400, and would lead to the conclusion that the taxpayer recognized debt discharge income on the adjustment.

The second is to examine the reasons for the adjustment, the approach courts have historically taken in applying the nonstatutory purchase price

239. The losing gambler is distinguishable in this regard from the concert-goer who does not enjoy the concert. It is true that the latter has little or no consumption value either. There is no administrable way, however, to tax happy and unhappy concert-goers differently. By contrast, we already tax winning and losing gamblers differently. There is no administrability problem in exempting the discharge of gambling debts; to the contrary, a rule subjecting such discharges to tax would likely be far harder to administer.

240. *See* United States v. Hall, 307 F.2d 238, 241 (10th Cir. 1962).

241. I.R.C. § 108(e)(5) would not apply to this adjustment for two reasons: (1) the debt is third-party debt, and (2) airline tickets represent services, not property. I.R.C. § 108(e)(5) (West 2006).

adjustment exception.[242] We might, for example, attempt to resolve *Zarin* by holding that the New Jersey casino credit laws were intended to protect gamblers; the unenforceability of Zarin's debts, in effect, might be treated as representing a legislative judgment that gamblers in Zarin's position were paying more than they should for what they were getting. Outside the casino context, New Jersey law affirmatively provides for the rescission of gambling transactions,[243] as do the laws of many other states.[244] Are such rescissions taxable? This seems intuitively implausible, yet the *Zarin* Tax Court majority opinion clearly implies that they are.

One final, and theoretically very important, question relating to markets may also bear on the *Zarin* issue: Is the taxation of nonmarket income authorized by the current Code at all? Haig-Simons suggests that it is—that all increases in wealth and all current consumption, whether or not realized in a market, are presumptively taxable under § 61 of the Code. Nevertheless, in practice nonmarket income is generally not taxed.

Some tax colleagues with whom I have discussed this issue explain the exclusion of nonmarket income as a matter of administrative grace; the IRS, they argue, simply chooses not to tax imputed and other nonmarket income, although statutorily authorized to do so. Such an explanation is problematic. Taxpayers have an obligation to self-assess. There is no substantial authority to the effect that imputed or other nonmarket income is excludible. The nonmarket economy, moreover, is huge. It seems unlikely that an administrative agency, without any formal deliberation or ruling, would exempt an entire sector of the economy from its purview.

I suggest that under current law the taxation of nonmarket income is not generally authorized—that is, that if the IRS sought to tax the imputed value of owner-occupied homes or other nonmarket consumption without first seeking an amendment to the Code, it would fail. In this regard, Haig-Simons neither describes nor justifies current law.[245]

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242. *See* Seto, *supra* note 26, at 272-81.

243. N.J. STAT. ANN. § 2A:40-5 provides as follows: "If any person shall lose any money . . . in violation of section 2A:40-1 of this title, and shall pay or deliver the same or any part thereof to the winner . . . such person may sue for and recover such money . . . from such winner." N.J. STAT. ANN. § 2A:40-5 (West 2005).

244. *See, e.g.*, ALA. CODE § 8-1-150 (2002); ARK. CODE ANN. § 16-118-103 (2006); D.C. CODE § 16-1702 (2005); GA. CODE ANN. § 13-8-3 (1981); KY. REV. STAT. ANN. § 372.020 (LexisNexis 2002); MD. CODE ANN., CRIM. LAW § 12-110 (LexisNexis 2002); MASS. ANN. LAWS ch. 137 § 1 (LexisNexis 2001); MICH. COMP. LAWS ANN. § 750.315 (West 2006); MISS. CODE ANN. § 87-1-5 (1972); MO. ANN. STAT. § 434.030 (West 1992); MONT. CODE ANN. § 23-5-131 (2005); N.M. STAT. ANN. § 44-5-1 (LexisNexis 2005); OHIO REV. CODE ANN. § 3763.02 (LexisNexis 2005); OR. REV. STAT. ANN. § 30.740 (West 2005); S.C. CODE ANN. § 32-1-10 (1991); S.D. CODIFIED LAWS § 21-6-1 (2004); TENN. CODE ANN. § 28-3-106 (2003); VA. CODE ANN. § 11-15 (1999); W. VA. CODE ANN. § 55-9-2 (West 2000).

245. I offer a possible alternative theory. The federal income tax is not most accurately characterized as a tax on income; it is better conceived as a tax on market transactions measured by income. As a tax on market transactions, it is one of the broadest taxes currently practicable. One of the principal functions of government is to create and protect markets; a tax on market transactions is therefore justified on the ground that it is imposed

Current law distinguishes between taxable market activity and nontaxable nonmarket activity primarily on the basis of formal indicators—particularly the passage of money. In *Commissioner v. Daehler*, for example, a real estate broker handled his own home purchase and, as a result, was repaid a portion of the brokerage fee that he paid on the purchase.[246] In other words, the broker's cash traveled to the seller, to the broker's employer, and then back to broker, all in payment for services the broker had performed for himself. Had no cash passed, it is almost certain that the value of those services would never have been taxed. Because the transaction passed through the market, however, the court held that the broker was taxable on the brokerage fees that he, in effect, paid himself.[247]

Is the provision of gambling consumption value a market activity? If not, we should exempt the consumption value of gambling even if we conclude that gambling is consumption. Clearly Resorts looks a lot like any other commercial service provider, regulated the way other market participants are regulated. Zarin, it would appear, went into the market to gamble.

The problem is that a poker game at Resorts International is formally indistinguishable from a nonmarket kitchen poker game. Both use cash; both use the same rules. Our rules for the taxation of gambling must work in both market and nonmarket contexts. If we propose to tax the consumption value of poker at Resorts, it becomes very difficult to avoid taxing the consumption value of the kitchen poker game.

Assume that the Tax Court majority opinion in *Zarin* becomes the law. You and I play poker at my kitchen table. You ante in an IOU, unenforceable under state law, and lose, but you never pay. The Tax Court majority opinion tells us that you must report taxable income in the amount of that IOU, representing the consumption value of that poker game to you. As a matter of law, if you have read and understood *Zarin* and willfully omit that IOU from your return, you have committed a felony. I doubt that the Tax Court majority intended to hold so.

And therein lies yet another problem in the structuring of workable rules for the taxation of gambling debt discharges. Gambling is ambiguous not merely as to whether it is a consumption or on income-producing activity. It is also formally ambiguous as to whether it is a market or non-

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on those who benefit from government activity. Because it is measured by income, it is also fair because it is imposed on those with the ability to pay.

The foregoing theory, unlike more conventional explanations, provides guidance as to the appropriate international scope of the United States income tax: the tax should be imposed on those who benefit from the market-creating and -protecting activities of the United States government. It also suggests that the corporate income tax may not, in fact, be a double tax. Corporations benefit from markets and are therefore subject to tax; their shareholders benefit in the course of different market activities and should also be subject to tax. Most pertinent to *Zarin*, this theory suggests that nonmarket activities are exempt from tax as a matter of congressional will, not as a matter of administrative grace.

246. Comm'r v. Daehler, 281 F.2d 823, 824-25 (5th Cir. 1960).

247. *Id.*

market activity. The Code clearly taxes net gambling winnings. Taxing the consumption value of gambling in market contexts, however, would require a far more complex set of rules than we currently have—rules that would distinguish market from non-market gambling and consumption from income-producing gambling. I wonder whether the resulting mess would make anyone happier.

D. The Problem of Statutory Interpretation

The Code, of course, is a statute, and *Zarin* a case of statutory interpretation. Nontax scholars and judges may therefore find elements of the foregoing discussion of theory puzzling. When, after all, did Professors Haig and Simons get the authority to interpret the Code? Should we not instead inquire as to the language, intent, and purpose of the statute, applying standard canons of statutory construction as did Judges Ruwe and Cowen? After all, the ultimate issue was not whether Zarin had untaxed Haig-Simons consumption. The ultimate issue was the proper construction of the Code.

The evident lack of consensus regarding the *Zarin* case within both the courts and the scholarly community reflects a larger lack of consensus about statutory interpretation itself. Traditionally, courts have attempted to construe statutes in a manner consistent with the "intentions" of the enacting legislature, focusing on legislative history and similar evidence of legislative "intent."[248] It has been objected, however, that collective bodies cannot have "intentions," that in fact much legislation reflects pluralist or rent-seeking compromises by legislators with widely disparate motives.[249] This has resulted in proposals to limit judicial inquiry to the "plain language" of the statute itself, excluding all inquiries as to motive or reason; absurd outcomes, proponents argue, should be corrected by the legislature.[250] Strict plain language approaches, however, are often

248. *See, e.g.*, Comm'r v. Engle, 464 U.S. 206, 214 (1984) (finding that discovery and application of legislative intent is a court's sole task); 2A J.G. Sutherland, Statutes and Statutory Construction § 45.05 (4th ed. 1984) (noting that the "intent of the legislature" is the criterion most often cited in statutory interpretation); Learned Hand, *How Far Is a Judge Free in Rendering a Decision?*, *in* The Spirit of Liberty: Papers and Addresses of Learned Hand 103, 105-10 (3d ed. 1960). *See also generally* Daniel A. Farber, *Statutory Interpretation and Legislative Supremacy*, 78 Geo. L.J. 281 (1989); Earl M. Maltz, *Statutory Interpretation and Legislative Power: The Case for a Modified Intentionalist Approach*, 63 Tul. L. Rev. 1 (1988); Roscoe Pound, *Spurious Interpretation*, 7 Colum. L. Rev. 379, 381 (1907).

249. *See, e.g.*, William N. Eskridge, Jr., Dynamic Statutory Interpretation 16-25 (1994). *See generally* Kenneth A. Shepsle, *Congress Is a "They," Not an "It": Legislative Intent as Oxymoron*, 12 Int'l Rev. L. & Econ. 239 (1992).

250. *See, e.g.*, Frank H. Easterbrook, *The Role of Original Intent in Statutory Construction*, 11 Harv. J.L. & Pub. Pol'y 59 (1988). *See generally* William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. Rev. 621 (1990) (discussing the use of textualism by Justice Scalia); Richard Pildes, Note, *Intent, Clear Statements, and the Common Law: Statutory Interpretation in the Supreme Court*, 95 Harv. L. Rev. 892 (1982); Patricia M. Wald, *The Sizzling Sleeper: The Use of Legislative History in Construing Statutes in the 1988-89 Term of the United States Supreme Court*, 39 Am. U.L. Rev. 277 (1990); Nicholas S. Zeppos, *Justice Scalia's Textualism: The "New" New Legal Process*, 12 Cardozo L. Rev. 1597 (1991).

both indeterminate and rigid. Legislatures, moreover, do not necessarily cooperate by correcting absurd outcomes. A plain language approach, therefore, may simply lead to absurd law. This possibility, in turn, has reinvigorated proposals to construe statutes in a manner consistent with their "purpose"—inferred primarily from the structure of the statutes themselves and the historic contexts in which they were enacted.[251] Whether "purpose" is really different from "intention," however, is questionable.[252] More recently, Professor Eskridge has suggested that over time courts inevitably and properly depart from all such archeological inquiries; the interpretation of each statute does and should develop its own evolving logic independent of the original legislative will.[253] But Eskridge's approach, known as "dynamic" statutory interpretation, comes uncomfortably close to suggesting that courts can and should legislate.

Each of these schools has its exemplar among the *Zarin* opinions. Judge Ruwe argued that standard indicators of congressional intent supported the conclusion that § 108(e)(5) exempted Zarin's debt discharge income. Judge Cowen, for the Third Circuit, apparently used a plain language approach in applying both § 108 and the disputed debt exception—persuading no one in the process.

The principle of complete accounting, which requires rejection of both the § 108(e)(5) argument and Judge Cowen's extravagant explanation of the disputed debt exception, is easy to justify by reference to the purposes of the Code as a whole. The evident purpose of the Code is to tax "income"; the principle of complete accounting is necessary to measure income correctly; it follows that the provisions of the Code should be construed, to the extent possible, in a manner consistent with that principle.

The Tax Court majority's implicit reliance on the Haig-Simons definition of income, by contrast, is probably an example of dynamic statutory interpretation. Neither Congress nor the Supreme Court has ever endorsed Haig-Simons. Even *Collins*, at the time the only federal income tax case ever to invoke Haig-Simons explicitly as a rule of decision, acknowledged that "[j]ust as 'the Fourteenth Amendment does not enact Mr. Herbert Spencer's Social Statics', the [sixteenth] Amendment does not enact the Haig-Simons definition of income. . . ."[254] Nevertheless, Haig-Simons is close to becoming part of the evolving logic of the Code. With *Collins*, Haig-Simons may well be slouching towards Bethlehem to be born.[255]

251. *See, e.g.*, HENRY HART & ALBERT SACKS, THE LEGAL PROCESS 1415 (1994); Deborah A. Geier, *Interpreting Tax Legislation: The Role of Purpose*, 2 FLA. TAX REV. 492 (1995).

252. *See, e.g.*, ESKRIDGE, *supra* note 249, at 31-34.

253. *Id.* at 48-49.

254. Collins v. Comm'r, 64 T.C.M. (CCH) 557, 564 (1992) (citations omitted).

255. My apologies to Yeats. *See, e.g.*, WILLIAM BUTLER YEATS, THE SECOND COMING AND OTHER POEMS 76 (2000).

How, then, should we resolve *Zarin*? Should we merely agree to disagree until consensus develops around a common approach to statutory interpretation? I suggest not. *Zarin* itself illustrates many of the strengths and weaknesses of the various approaches; an understanding of the case may actually help us move in the right direction, however incrementally, on the larger interpretive issues.

First, if nothing else, it should be clear from the general response to the Third Circuit's opinion that a flat-footed plain language approach to interpretation of the Code does not work. By this I mean it does not persuade, and leaves the court using it open to ridicule even if the court thereby reaches the "right" result. I suggest further that any approach to statutory interpretation that cannot be used in the tax arena—the quintessential statutory context—is of dubious value.

Second, the debate over whether Congress can have "intent" is largely academic. Even if Congress merely pretends to have reasons for what it does, courts are obliged to respect those reasons, and they generally do. The harder question is how to resolve apparent conflicts between the legislative "intent" or statutory "purpose" of a particular provision and that of the statutory system as a whole. Judge Ruwe's interpretation of § 108(e)(5) may have been consistent with the legislative history of that section read in isolation but, it ignored the principle of complete accounting that seems compelled by the purposes of the Code as a whole. In the absence of an express intention to override that principle, I suggest, Ruwe's restricted inquiry was wrong.

Third, whether the Haig-Simons definition of income requires a victory for Zarin or the IRS depends, I have argued, on whether winning is more fun than losing. I think it is, and therefore believe that, in general, gamblers get little or no consumption value from losing. If so, we need not decide whether Haig-Simons has yet been incorporated into the logic of the Code since, in the absence of such incorporation, precedent would have required a judgment for Zarin.

Finally, *Zarin* suggests that we should be cautious about raising Haig-Simons to the status of law. Scholars love the power Haig-Simons gives them; we can declare courts and Congress "wrong" simply by appealing to principle. Nevertheless, the lay sensibilities that courts and Congress bring to issues of tax policy should not be ignored. I suspect that the Tax Court dissents and the Third Circuit majority were all founded, at least in part, on an intuition that Zarin's situation was simply not what Congress intended to tax when it enacted the Internal Revenue Code—regardless of theory and logic-chopping lawyers. Formal adoption of Haig-Simons as a rule of decision might well promote internal consistency and theoretical purity; but it might also move the federal income tax system one step further away from the commonsense notions of fairness that led to its enactment in the first place. If we are forced to choose, legitimacy is more important than purity.

CONCLUSION

Of the various opinions rendered in the *Zarin* case itself, Judge Tannenwald's had perhaps the most to commend it. As I hope this article demonstrates, the theoretical, doctrinal, and practical issues raised by the *Zarin* facts were thorny. The case itself, unusual in many regards, was simply not the right vehicle for resolving them all. Judge Tannenwald's approach would have disposed of the actual lawsuit without any significant precedential effect. Law professors would have been deprived of a wonderful teaching tool, but the real world would not have blinked an eye.

What is the law currently? In *Rood v. Commissioner*, the Tax Court held that a casino gambler was taxable on the discharge of his casino debt where there were no disputes about either the enforceability or the amount of the debt.[256] This is, I suggest, a bizarre rule, not justifiable by theory or statute. Under this rule, the discharge of gambling debts incurred in Nevada apparently will be taxable only if each debs are evidenced by a credit instrument, since gambling debts are not otherwise legally enforceable in that state.[257] The taxability of gambling debt discharges in states like New Jersey, where gambling debts are enforceable in some contexts and not others, will apparently turn on whether taxpayer hires a lawyer to contest the casino's collection efforts before facing the IRS. And in the Tenth Circuit, *United States v. Hall* is probably still the law.[258]

What is the "right" answer? A strong practical argument can be made that unenforceability should not determine whether discharged gambling debt is taxable. A strong theoretical argument can be made that losing 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*.[259]

I close by returning to the real world. To say that Zarin "won" is true only in the sense that surviving a ten-year nightmare is victory. In truth, both Zarin and the IRS lost—all, it appears, because of a case that began largely by accident. *Zarin*, I suggested at the outset, is a story of how law works, and how it sometimes fails. In David Zarin's case, it failed.

256. *See generally* Rood v. Comm'r, 71 T.C.M. (CCH) 3125 (1996).
257. *See supra* note 174.
258. *See generally* United States v. Hall, 307 F.2d 238 (10th Cir. 1962).
259. For this purpose, I mean solely debts incurred in the course of gambling, not third-party debts the proceeds of which are then lost in gambling. Debt incurred for the purchase of lottery tickets need not, for this purpose, be treated as gambling debt, since it is not subject to the one-step accounting analysis applicable to casino and similar debt. Thus *Collins v. Commissioner*, 64 T.C.M. (CCH) 557 (1992), would not necessarily be inconsistent with my proposed rule.

POSTSCRIPT

David Zarin passed away on November 18, 2005. His obituary in the Press of Atlantic City recalled his real claim to fame, for which he much preferred to be remembered:

> Mr. Zarin was born in New York City and raised in Newark. After graduating from the Newark College of Engineering, he began a long and illustrious civil engineering and business career. He served as a naval architect in Philadelphia during World War II. For the past four decades, he developed numerous nursing homes and nearly 4,000 units of low and moderate income and senior housing in Pennsylvania, New Jersey, and Florida. In Atlantic City, Mr. Zarin helped start the revitalization of the South Inlet area with such landmarks as New York Ave., Garden Court, Vermont Plaza, Lighthouse Plaza, Metropolitan Plaza, and many others. A dedicated civic leader and contributor to Atlantic City community projects, he donated the 5,000 sq. ft. Sencit Baltic Family Practice Clinic, renovated one of Atlantic City's best known landmarks, the World War I memorial on Albany Ave., was a long-time benefactor of the South Jersey Theater in Somers Point, and was a long-time supporter of the Atlantic City Council of the Arts. He received numerous awards and honors, including being named Citizen of the Year by the Atlantic City Chamber of Commerce, was a recipient of the community's Inter-Racial Award, and honored with the Alfred M. Heston Award from the Atlantic City Public Library.[260]

Helen W. Walsh, former Administrator of Atlantic County, N.J., eulogized Zarin in the following terms: "David Zarin, a pioneer in the field of affordable housing, tackled the issue here long before anyone else and left a legacy of bricks and mortar in Atlantic City."[261] He "will be sorely missed."[262]

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260. Obituaries, ATLANTIC CITY PRESS, Nov. 20, 2005, at E2.
261. Helen W. Walsh, Letter to the Editor, ATLANTIC CITY PRESS, Jan. 1, 2006, *available at* http://www.pressofatlanticcity.com/opinion/letters/story/5817779p-5833831c.html.
262. *Id.*

Comments

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