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LEGAL AND TAX INCIDENTS OF COMPULSIVE BEHAVIOR: LESSONS FROM ZARIN

Babette B. Barton*

Zarin v. Commissioner1 reports the pitiable tale of a compulsive gambler2 who, by repeated rolls of the dice at an Atlantic City casino, in barely two years time lost $2.5 million of his own funds and almost $3.5 million in chips furnished him on credit by the casino. Zarin succeeded in settling the debt to the casino for $0.5 million, only to face an income tax assessment of ten-fold that amount attributable to the canceled portion of the debt.3 Zarin's bad luck continued at the trial of the tax deficiency. He lost in the Tax Court, eight judges out of nineteen dissenting, but ultimately prevailed on appeal to the Third Circuit by a 2-to-1 decision. These divisions among the jurists have their parallels among the commentators.4 Even those in favor of the Third Circuit decision characterize it as the right result for the wrong reason,5 with little consensus as to what grounds are right.6

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2 The Tax Court found that by January 1980 Zarin was "gambling compulsively." The opinion recites that he was gambling twelve to sixteen hours a day, seven days a week, betting up to $15,000 on each roll of the dice, and unaware of the amount of his gambling debts. 92 T.C. at 1087-88.
3 At Zarin's 70% tax bracket for 1981, his deficiency and interest attributable to the $2,935,000 cancellation of debt income amounted to $5,209,033.96. 916 F.2d at 112.
5 See, e.g., Dodge, supra note 4, at 678, 683 n.33 ("Ironically, the worst opinion in Zarin, that of the Third Circuit majority, came closest to the right result."); Gunn, supra note 4, at 893; Johnson, supra note 4, at 697-99; Shaviro, supra note 4, at 252-58.
6 The competing views are discussed in the text in Part II of this article. As of January 1992:

   a. Professor Gunn's approach in favor of the taxpayer received written endorsement from Professors Andrews and Dodge. See WILLIAM D. ANDREWS, TEACHER'S MANUAL TO BASIC FEDERAL INCOME TAXATION 39 (4th ed. 1991) ("This case is a circus. I think the
If fame were a sure precursor to fortune, Zarin's material troubles would be over. His case is already widely celebrated in texts and commentary. Its place in the classroom seems equally assured; one professor describes it as "a splendid mix of colorful facts and interesting legal questions," and another as "of intense interest to teachers of federal income tax since it offers a convenient vehicle to discuss numerous aspects of the theory of 'gross income,' virtually all aspects of cancellation-of-indebtedness income, transactional accounting issues, and the borderline between income-producing activity and personal consumption." Some even use it to illustrate the familiar adage about hard facts making bad law. But none of these descriptions does it justice.

result is right, despite the contrary quality of the Court of Appeals opinions, for reasons very succinctly put by Alan Gunn...); accord Dodge, supra note 4, at 681 n.23.
b. An intended collaborative response to Professor Shaviro by Professors Dodge and Johnson culminated in pro-taxpayer analyses that are at odds with Professor Shaviro and decidedly distinct from one another. See Johnson, supra note 4, at 697, 704 n.31.
c. Professor Kahn dismisses the anti-taxpayer result in the Tax Court as unduly harsh, and proposes that it be replaced by another view that he concedes no court has yet adopted. Kahn, supra note 4, § 2.1295.
d. Professor Chirelstein takes a somewhat more agnostic approach that suggests the possibility of differentiated results depending on the size of the canceled debt:

What is affecting about the taxpayer's position, of course, is the fact that his debt was the product of a rather pitiable mental state, which the casino did not hesitate to exploit. On the other hand, the law obviously cannot assess consumption benefits on an individual basis or depart from the general rule that benefit is measured by market price. Thus, while most nonaddicted people would agree that the consumption benefits realized by an addict are negative if viewed objectively, presumably a "sick gambler" exception to the Kirby Lumber rule would be unworkable as an administrative matter. In the end, therefore, it might be simplest if the Service read the Zarin decision to mean that the settlement of any sizeable gambling debt implies or presumes a prior informal understanding between the parties. Evidenced by the settlement itself, the implied understanding is that large players who are also heavy losers may ultimately be entitled to a volume discount.

Chirelstein, supra note 4, at 57.
e. Professor Newman and this author would each have denied the taxpayer relief on the facts, at least in the absence of insolvency that would have tipped the scales the other way by virtue of section 108(a)(1)(B). See Newman, supra note 4, at 667.


Gunn, supra note 4, at 893; see also Shaviro, supra note 4, at 215 ("For human and intellectual interest, few recent tax cases can compare. . . .").

Dodge, supra note 4, at 677.

Compare Chirelstein, supra note 4, at 57 ("Only a grouch would object to the outcome."); with Kahn, supra note 4, § 2.1297-2 (characterizing the anti-taxpayer result in the Tax Court as "extremely harsh") and Shaviro, supra note 4, at 252 (admitting to violating a usual tax rule in order to reach a pro-taxpayer result). These responses suggest that in a trial before a jury Zarin
The Zarin case has all the makings of a modern classic, true to the Palsgraf\textsuperscript{11} tradition. Its issues of foreseeable risks, causal connections, and scope of responsibility transcend the tax law and mere gambling over gambling and canceled debts. They assume sweeping contemporary significance when played out against the facts of Zarin—a context that inherently bids attention to what relevance and role compulsive behavior should play in legal controversies. A recent commentary on Zarin was the opening round of these escalating stakes.\textsuperscript{12} Professor Shaviro presents a scholarly case for granting special tax consideration to behavior related to or caused by compulsion. Several others have since distanced themselves from his line of reasoning,\textsuperscript{13} yet they and the broader published reactions to Zarin almost uniformly share his taste for the favorable Third Circuit decision, if not its reasoning.\textsuperscript{14}

Prompted by a concern over the implications of the Zarin decision, and the apparent overwhelming support for the taxpayer within the academy, this article offers a largely contrary perspective. It attempts to show that, on the facts of Zarin, arguments in support of the taxpayer logically depend upon granting a special legal dispensation to his compulsive condition. The thesis of this article is that the task of working out legal accommodations to compulsive behavior should, at least in the tax field, be left to legislation, not attempted in ad hoc determinations by case law under any doctrinal guise. The potential for inequities among taxpayers is too profound, and the implications beyond the tax law too far reaching.

Part I of this article briefly presents and comments on the salient facts of Zarin to delineate the crux of the dispute, and the precedential significance of the case. Part II surveys the views expressed about the issues in Zarin by commentators as well as the Tax Court and Third Circuit opinions. These and other positions that might have been raised are assessed therein. Part III addresses the troubling implications of adjudications in favor of a taxpayer like Zarin, and concludes that these call for congressional rather than judicial relief.

I. FACTUAL AND DOCTRINAL BACKGROUND

As already indicated, the Service argued that Zarin's settlement of a $3.435 million gambling debt for $0.5 million created cancellation of debt (''COD'') income equal to the difference. The theory was that the taxpayer enjoyed an accession to wealth, hence income, as a result of borrowing without repaying the canceled portion.\textsuperscript{15}

might have fared better than he did in his chosen forum of the Tax Court, even without regard to the typical pro-taxpayer bent of jurors in contrast to Tax Court judges. To proceed so, however, would have required payment of the deficiency and a suit for refund by Zarin in a district court, a solution that was probably beyond the taxpayer's means.

\textsuperscript{11}Palsgraf v. Long Island R.R., 162 N.E. 99 (N.Y. 1928).
\textsuperscript{12}Shaviro, \textit{supra} note 4.
\textsuperscript{13}See Dodge, \textit{supra} note 4; Johnson, \textit{supra} note 4; Newman, \textit{supra} note 4.
\textsuperscript{14}See generally authorities cited \textit{supra} note 4.
\textsuperscript{15}For those unfamiliar with the concept of income from the discharge of indebtedness under section 61(a), a short description will perhaps suffice. An elegant and fuller explanation appears elsewhere.

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The taxpayer countered on a number of grounds. One argument became a centerpiece of the Third Circuit decision in Zarin’s favor: that because Zarin’s gambling debt was unenforceable under local law, it could not generate income to him upon its cancellation.\(^6\) Zarin also pressed the wholly novel theory that his compulsive condition drove him inevitably to lose all loan proceeds made available to him. As a result, according to Zarin’s reasoning, he did not receive anything of value either from the loan or the settlement agreement.\(^7\) This is the theory expanded upon by Professor Shaviro, and the prompting for this article.

All the facts of the case were stipulated, including, first, that Zarin was a ‘‘compulsive gambler’’ when he ran up $3.435 million in gambling debts.\(^8\) This obviously eliminated the critical difficulty of proving that the behavior was compulsive, which others in the future might face if compulsive conditions are relevant to adjudicated outcomes. The stipulations said nothing of Zarin’s general mood and state of mind while gambling/losing, either from the vantage of introspection, or of observers including trained experts. The topic of Zarin’s enjoyment or other possible values derived from his gambling was a central feature in Professor Shaviro’s work. It was also the subject of considerable contradictory speculation by other commentators.

A second stipulated fact was that the credit extended to Zarin by the casino was in the form of chips, not cash, which constituted a nonnegotiable medium of exchange usable only at the casino.\(^9\) As discussed more fully below, this prompted some of the commentators and judges to conclude that the loan did not have a full $3.435 million cash equivalent value at the outset upon which to base $2.935 of COD income when only $0.5 million was repaid. The Tax Court majority, by contrast, concluded that Zarin received ‘‘full value’’ for the $3.435 million that he bargained for and agreed to repay\(^20\)—over $3 million worth of chips, plus benefits of meals, lodging, limousine service, and the like, for himself and his guests that the casino provided to him as a valued gambling patron. This was a crucial factual difference that divided the pro-Zarin from the anti-Zarin camp.

\(^6\)See generally Boris I. Bittker & Barton H. Thompson, Jr., Income from the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co., 66 CALIF. L. REV. 1159 (1978); see also CHIRELSTEIN, supra note 4, § 3.02. Stated briefly, the doctrine asserts that income results to the extent that a debt is canceled for less than the amount owed; otherwise, as a result of a taxpayer’s right to receive assets tax-free at the time of borrowing, an unaccounted-for increase in the borrower’s wealth would occur if those assets were not included in income when the debt was canceled at a discount. Alternatively, the doctrine is sometimes explained on the ground that cancellation of the debt concomitantly frees the debtor’s assets for other uses and enjoyment from the pre-existing encumbrance of the debt.

\(^7\)See generally infra text accompanying notes 32-46 (discussing relevance of unenforceability of a debt to a finding of COD income).

\(^8\)See infra text accompanying note 117 (Tax Court’s restatement of Zarin’s argument that he did not receive anything of value from the loan or settlement agreement).

\(^9\)See Zarin v. Commissioner, 92 T.C. 1084, 1087 (1989), rev’d, 916 F.2d 110 (3d Cir. 1990); see also supra note 2 (noting the facts on the extent of Zarin’s gambling habit).

\(^20\)Id. at 1096.
Another of the trial stipulations asserted that at the time of the borrowing and even after all his losses, Zarin intended to repay the $3.435 million debt in full.\(^{2}\) Only when the chips were down,\(^{22}\) and the casino sought to collect the debt in court, did Zarin raise the affirmative defense\(^{23}\) that the casino’s violations of gaming regulations on granting credit might have resulted in unenforceability of the debt.\(^{24}\)

A further uncontroverted fact was that the burden of proof, which is normally on the taxpayer, in this case fell upon the Service. By initially assessing the tax deficiency on grounds of income from larceny by trick or deception, the Service’s later shift to grounds of income from discharge of indebtedness represented the raising of a “new matter,” and hence the recasting of the burden of proof.\(^{25}\)

A significant omission from the stipulations and arguments at trial was any reference to Zarin’s possible insolvency when his debt was canceled. In a motion for reconsideration of the Tax Court’s decision, Zarin for the first time claimed automatic entitlement to statutory relief from COD income based on his insolvent status.\(^{26}\) This was raised too late, however, for the Tax Court to consider.\(^{27}\)

What is clear from a review of the Tax Court record is that Zarin’s suit was not one for tax relief from a canceled debt of a compulsive gambler who was free to apply the proceeds of borrowing to any desired use, nor a case seeking tax relief for losses incurred from compulsively betting the taxpayer’s own accumulated after-tax wealth. Neither factual scenario received express attention by the pro-taxpayer camp of judges and commentators, or by Zarin himself, even though the facts in his case could have been used to raise those matters. The opinions of the dissenters in the Tax Court and the majority on appeal were silent about the implications of their pro-Zarin reasoning when applied to such other scenarios. Nor did they address the likely inequities of attempting to distinguish those and other cases from Zarin’s.

II. ANALYSIS OF ARGUMENTS FAVORING THE TAXPAYER

Of all the pro-Zarin arguments appearing in the reported opinions of the case and commentary on it, only one\(^{28}\) addresses the subject of tax relief for Zarin by attention to his compulsive condition. The others support a reduction in Zarin’s tax burden on more traditional grounds. This article attempts to demonstrate that if the arguments based on traditional tax doctrine are to succeed, they too must come to grips with Zarin’s compulsive condition or with developed attitudes toward it in the fields of contract or tort law. Whether as a policy matter the

\(^{21}\)Id. at 1086-87.

\(^{22}\)Sorry—(to borrow Professor Newman’s reaction to his own description of an argument as “dicey.”) See Newman, supra note 4, at 669 n.16).

\(^{23}\)92 T.C. at 1088.

\(^{24}\)See supra text accompanying notes 29-32 (discussing the unenforceability of Zarin’s debt).

\(^{25}\)92 T.C. at 1088-89.

\(^{26}\)See I.R.C. § 108(a)(1)(B).

\(^{27}\)916 F.2d at 112 n.6.

\(^{28}\)See infra Part II.D. (“Losses from Compulsive Conduct Dispel the Benefit or Consumptive Value Essential to a Measurement of Income”).

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arguments as so revised deserved to prevail presents a separate issue, deferred for analysis to Part III.

A. Cancellation of a Debt Contested as Unenforceable

On appeal, the two-judge majority of the panel held that Zarin had no income from his arms’ length settlement of the debt that he contested as unenforceable. The unenforceable nature of the debt, and the fact of its contest, provided the two independent grounds of the Third Circuit decision.

Unlike gambling debts that are unenforceable in most other states, Zarin’s debt arose in an Atlantic City casino and would have been wholly valid and enforceable under New Jersey law but for the casino’s violation of the State’s gaming regulations by failing promptly to cash the borrower’s check or note. These violations became the basis of Zarin’s contest of the collection suit against him by the casino. In the tax litigation, with the burden of proof on the government and without further evidence on the subject, both the Tax Court and Third Circuit decisions assumed the debt to be unenforceable.

1. Settlement of an Unenforceable Debt

The first part of the Third Circuit majority opinion rejected COD income to Zarin on the ground that section 108, which is the only Code provision to elaborate on such income, literally applies only to debts when responsibility for repayment rests either on the debtor or the debtor’s property. In the court’s view, Zarin’s unenforceable gambling debt fit neither description. The correctness of this interpretation is at the least questionable in light of the Supreme Court’s expressed attitudes about the immateriality for tax purposes of whether

32Zarin, 92 T.C. at 1090; 916 F.2d at 113 & n.7. In fact, the loans of the type made to Zarin by the casino, as well as some side advances to him by another creditor, were eventually held to be unenforceable under New Jersey law. See Nemtin v. Zarin, 577 F. Supp. 1135 (D. N.J. 1983); Salomone, 429 A.2d 1078. The Tax Court concluded that, with the burden of proof on the government, the failure to disprove the allegation about the unenforceability of the debt forced it to accept the allegation as valid. 92 T.C. at 1090. The court went on to hold, however, that the unenforceability of the debt was irrelevant to the outcome, if, as it felt was true on these facts, the taxpayer received a benefit from that unenforceable loan. Id. at 1091-1095. For this proposition it properly relied on Commissioner v. Tufts, 461 U.S. 300 (1983). See infra text accompanying notes 35-46 (discussing Tufts).
33The opinion quotes the statute as applying only to indebtedness ‘‘(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property.’’ 916 F.2d at 113 (quoting I.R.C. § 108(d)(1)).
a debtor is or is not personally liable for a debt. Moreover, if section 108 were so limited, this should merely have foreclosed the statutory accommodations available under that relief measure. A determination of the inapplicability of section 108 to the unenforceable gambling debt should have shifted the inquiry to why the discharge occurred, and to whether a discharge for that reason amounted to a taxable accession to wealth.

That income can arise upon relief from a debt for which the debtor is not personally liable, and even though section 108 does not apply, was settled by the Supreme Court in Commissioner v. Tufts. At issue in Tufts was the tax consequence to the seller when property encumbered by a nonrecourse debt was sold at a price below the principal still owing on that debt. The Court refused to characterize the seller's gain on the sale as "cancellation of debt income," and went on to impose a capital gain tax on the debtor.

The Court relied on a notion of symmetry in reaching its decision that income, even if not COD income, can result from the discharge of such a debt:

The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property.

Stated differently, the Court reasoned that the mortgagor had been allowed to enjoy a tax-free receipt on acquiring the property secured by the loan, as though the loan at that time were fully enforceable; hence, symmetry required the mortgagor to recognize income when the loan was later discharged for a lesser figure, just as though on this later event an enforceable debt had been canceled.

34See infra text accompanying notes 35-38 (discussing usual irrelevance in the eyes of the tax law under the Tufts' doctrine of whether debtor is personally liable for the debt).

35"Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment rather than under the debt discharge rules." S. REP. No. 1035, 96th Cong., 2d Sess. 8 n.6 (1980) (citing Regs. § 1.61-12(a)). See OKC Refining, Inc. v. Commissioner, 82 T.C. 638 (1984); BITTKER & LOKKEN, supra note 7, 6.4.7, at 6-66.

See generally United States v. Centennial Sav. Bank, FSB, 111 S. Ct. 1512, 1518 (1991) (discussing the statutory purpose of section 108 and its scope). As to the scope of section 108, the Court held that the section applies only to cases of "discharge" from debt—that is, "cancellation of a pre-existing repayment obligation." Id. at 1519 (emphasis added). No reference was made to the relevance, if any, of the enforceability of that obligation. As to the purpose of section 108, the Court described the section as providing a mechanism of authorized adjustments by which debtors could defer tax otherwise owing on COD income, in order that businesses not be discouraged by the prospect of immediate tax liability from taking advantage of opportunities to repurchase or liquidate their debts at less than face value. See H.R. REP. No. 855, 76th Cong., 1st Sess., 5 (1939); S. REP. No. 1631, 77th Cong., 2d Sess., 77-78 (1942).


37This is a debt that denies the creditor a right of recourse to collect against other than the property in which the creditor has taken a security interest.

38461 U.S. at 310-12, 310 n.11.

39461 U.S. at 310-11.

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Does the reasoning about symmetry in Tufts warrant taxing Zarin on the cancellation of his unenforceable gambling debt; did he derive a (tax-free) benefit from the unenforceable debt when incurred, beyond the $0.5 million for which he eventually settled? Some commentators argue that he did not, and thus that he did not realize income at the time of his settlement. The Tax Court majority repeatedly expressed the contrary view that the gambling loan had conferred a benefit on Zarin equal to its $3.435 face value. The Third Circuit never addressed the issue, and was obviously flawed in failing to do so.

The Third Circuit in Zarin relied in part on United States v. Hall, a case that permitted a debtor's tax-free discharge from an allegedly unenforceable gambling debt on the ground that the debtor derived no benefit from the debt. In Hall, the debtor took out a loan to finance some of his pre-existing gambling losses. The debtor then negotiated a settlement of the loan below face value after challenging it as an unenforceable gambling debt. The court in dictum observed that a debtor who receives loan proceeds of an enforceable debt, and then loses them, can have COD income notwithstanding the debtor's overall loss from the borrowing transaction. By contrast, the Hall court felt that the debtor in the case before it received no benefit from the loan. The court reasoned that the debt: 1) merely covered losses that had already been incurred, and 2) may itself have been an unenforceable gambling debt, the cancellation of which would therefore, in the court's view, be of no benefit to the taxpayer.

The Hall decision, however, is no longer a reliable precedent in light of the subsequent Supreme Court decision in Tufts. The gambler in Hall used the loan proceeds to repay the gambling losses that he had run up on credit in the course of gambling—an activity of some apparent benefit (e.g., entertainment value) the cost of which, the gambling losses, the taxpayer had not otherwise

40See infra Part II.B.
4192 T.C. at 1092, 1094, 1096.
42307 F.2d 238 (10th Cir. 1962).
43By so reasoning, the Tenth Circuit in Hall declined to follow an old Supreme Court decision, Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926), which later Supreme Court cases implicitly discredited. See infra notes 91-93 and accompanying text (discussion of Kerbaugh-Empire Co.). The majority opinion of the Tax Court in Zarin erroneously concluded that the Hall case relied on Kerbaugh-Empire Co. Zarin, 92 T.C. at 1091.
44It is unclear whether COD income does or should result if a debtor (e.g., on making a charitable pledge) did not acquire monetary proceeds or their equivalent on incurring the debt, and hence received nothing to warrant income under the symmetry theorem when the debt was canceled. See Bradford v. Commissioner, 233 F.2d 935 (6th Cir. 1956) (relieving a gratuitous accommodation endorser from income upon discharge of the debt); Commissioner v. Rail Joint Co., 61 F.2d 751 (2d Cir. 1932) (rejecting income on the repurchase of bonds at a below-issue price that had been earlier issued as a dividend). Both of these cases pre-dated Tufts. Perhaps neither continues to be good law, particularly the latter in which the debtor may have received some monetary benefit tax-free when the debt was first incurred, such as relief from its obligation to pay dividends to its shareholders. In any case, neither seems controlling for cases such as Zarin or Hall, in which the taxpayers, as discussed in the text, did receive cash equivalent benefits at the time that their debts were created, albeit not necessarily the face value of the loans. As the Tax Court in Zarin observed at several points, Zarin received a benefit at the outset in the form of an opportunity to gamble as well as chips that could have been turned in for cash. Zarin, 92 T.C. at 1092, 1094. See generally infra discussion in text accompanying notes 74-78.

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paid. Failure to repay those outstanding gambling losses presumably would have produced income to the debtor under the Tufts rationale. In turn, the debt before the Hall court was itself of benefit, for by incurring it the taxpayer forestalled the income that would otherwise have been due had the gambling losses themselves not been repaid. The unenforceability of the debt should have been immaterial if in fact the debtor derived a benefit from it. Moreover, to exclude the discharge of the debt from income on the ground that the canceled debt was utilized to cover gambling losses amounts indirectly to allowing those gambling losses to serve as a deduction from income, contrarily to the apparent legislative scheme on permissible treatment of gambling losses.

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

2. Settlement of a Contested Debt

The Third Circuit ruled in favor of Zarin on another ground distinct from the unenforceability of the debt. It alternatively relied on Zarin's good faith contest of the debt as preventing income to him upon settlement of the disputed debt:

Under the contested liability doctrine, if a taxpayer, in good faith, disputed the amount of a debt, a subsequent settlement of the dispute would be treated as the amount of the debt cognizable for tax purposes. The excess of the original debt over the amount determined to have been due is disregarded. . . . Accordingly, there is no tax consequence to the taxpayer upon payment.

In so ruling, the court promulgated an overly broad proposition. A bona fide contest and settlement of a debt does not materialize automatically into a tax-free outcome. If the nonpayment of debt can result in income to a debtor who bears no personal responsibility for the debt, as the Tufts case clearly established, it is hardly surprising for income to result upon relief from a debt that is contested solely on the ground of its alleged unenforceability against the debtor.

The majority opinion in the Tax Court expressly rejected the proposition that disputation of a debt assures an absence of income. It concluded that Zarin could not avoid income when the dispute was over the existence rather than the amount of the debt and when the debt did not arise out of a purchase of property.

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45That is, under the doctrine of COD income, had taxpayer Hall's debt been used for a legal purpose, rather than to cover gambling losses, its cancellation would have created income. Hence, Hall's gambling losses indirectly accounted for his escape from income.

46I.R.C. § 165(d); see generally infra notes 96-109 (discussing application of section 165(d)).


48Zarin, 92 T.C. at 1095-96.

49The majority and dissenting opinions of the Tax Court examined the language of section 108(e)(5) to determine if Zarin could avoid income under that provision. The terms of section 108(e)(5) automatically eliminate COD income from a reduction of a credit obligation that was incurred on the purchase of property, upon the debtor's election to reduce the basis of the property that was purchased on credit. The majority found the statutory exclusion to be inapplicable on the ground...
This view was obviously not regarded as dispositive by the Third Circuit judges, and to this author rightly so. It overlooks other possibilities, discussed in the paragraphs below, that could justify cancellation of a debt without attendant income as a result of a set-off based on contract or tort principles of local law.  

As a result, just as the Third Circuit overstated the rule on income exclusion, so the Tax Court omitted to acknowledge some possibly valid grounds for excluding the canceled portion of the contested debt.

The more accurate statement of the interrelationship between an arms' length settlement and the creation of reportable income is that a settlement occasions the same tax consequences as would a payment of a fully litigated claim. In this way out-of-court settlements are not artificially discouraged by unfavorable tax consequences that would have been avoided by successful litigation.

So applied to a settlement in reduction of a gambling debt, that approach treats the canceled portion of the debt as though litigation had either reduced the obligation or caused an offsetting payment from the creditor to the debtor, with tax status fixed accordingly. In terms of Zarin's case, it follows that if a $2.935 million refund payment to Zarin would have been reportable income by him as an accession to wealth—the traditional gauge of whether a taxpayer has income—so too would the benefit he derived from the canceled portion have been reportable, but not otherwise.

On the facts of Zarin, the best arguments for excluding the canceled portion of debt from Zarin's income trace to his compulsive condition. Adjustments in the debt for other reasons would likely have amounted to taxable accessions to Zarin's wealth.

For example, a settlement that produced a windfall benefit to Zarin, by relieving him from the debt for reasons unrelated to any obligations owed him by the creditor, would have resulted in income to Zarin. This might have been that Zarin had not bought "property." 92 T.C. at 1092. The Third Circuit decision agreed. 916 F.2d at 114. A contrary conclusion presumably would not have altered the outcome in Zarin. Had the chips been treated as property, and the basis been reduced correlatively to the canceled portion of the debt, use of chips at face value (rather than at basis) for purposes of gambling would have produced income equal to the difference.


See Lyeth v. Hoey, 305 U.S. 188 (1938); Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944).

But see KAHN, supra note 4, § 2.1214 (characterizing forgiveness of gambling debts as a "spurious discharge of indebtedness").


See generally authorities cited supra notes 35 and 50.

See United States v. Kirby Lumber, 284 U.S. 1 (1931); see also OKC Refining, Inc. v. Commissioner, 82 T.C. 638, 647 (1984). In OKC Refining, Inc., the Tax Court noted:

The rule of Kirby Lumber [that reduction or cancellation of a solvent debtor's fixed obligation constitutes income] is clearly applicable where the only relationship between the parties is that of debtor and creditor and where the creditor is willing to accept less than full payment in discharge of the debt because of his concerns about the debtor's solvency, or because a rise in interest rates has devalued the loan.

82 T.C. at 647.
the case had the casino decided to settle the suit against Zarin out of concern over adverse publicity, litigation costs, or the unlikelihood of recovering anything more from Zarin. Rules of local law on the unenforceability of gambling contracts furnish other plausible illustrations of windfall enrichment of Zarin. Were they to prevent the creditor from collecting the debt, in order to forestall intimidating collection practices or other potentially pernicious effects of loans to gamble,\textsuperscript{56} such rules would create a windfall benefit by permitting the debtor without charge to escape from repaying benefits derived from the loan.

Likewise, if Zarin’s debt had been reduced to compensate for the creditor casino’s willful misbehavior, this implicit payment of punitive damages also should have caused Zarin income.\textsuperscript{57} The record is replete with evidence of misconduct by the casino justifying such an award. The State imposed fines on the casino for extending credit to Zarin\textsuperscript{58} in violation of an emergency order issued to the casino by the New Jersey Casino Control Commissioner,\textsuperscript{59} an order probably motivated by the State’s interest in deterring loan shark practices\textsuperscript{60} or other predatory tactics.\textsuperscript{61} The fines for repeated violations indicate that the ca-

\textsuperscript{56}If local law denies enforcement by the creditor, it does so for reasons of public policy, not out of a denial that enrichment of the debtor did occur as a result of the unenforceable debt. See generally 2 George E. Palmer, The Law of Restitution § 8.5, at 201 & nn.24 & 28 (1978) (a loan of money to enable a gambler to repay an illegal gambling debt may itself be illegal yet create a right of restitution from the debtor who would otherwise be unjustly enriched, unlike a loan to enable the borrower to gamble that affords the creditor no right to relief); accord L.S. Tellier, Annotation, Right to Recover Money Lent for Gambling Purposes, 53 A.L.R.2d 345, 348, 367 (1987).

\textsuperscript{57}E.g., Glenshaw Glass Co., 348 U.S. 426. If the punitive damages were part of a personal injury award, it is now clear as a result of a 1989 statutory amendment that such damages could not be excluded from income under section 104(a)(2) if the claim arose “‘in connection with a case not involving physical injury or physical sickness.’” See I.R.C. § 104(a) (last sentence, added by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7641(a), 103 Stat. 2106, 2379).

\textsuperscript{58}Zarin v. Commissioner, 92 T.C. 1084, 1088 (1989); 916 F.2d 110, 112 n.4 (3d Cir. 1990).


\textsuperscript{60}See, e.g., King Int’l Corp. v. Voloshin, 366 A.2d 1172 (Conn. Super. Ct. 1976), holding that despite legalization of gambling loans by recent state legislation, the extension of credit to participate in gambling still created an unenforceable loan as against public policy.

One need not have the gambling sagacity of the famed Las Vegas oddsmaker Jimmy the Greek to recognize the potential dangers in the extension of credit to the gambler [i.e., the loser frequently being driven to embezzlement and financial ruin] or the possibly unfortunate incidents, to employ a euphemism, that could well result from the nonpayment of the gambling bettor to his creditor.

\textsuperscript{61}See, e.g., King Int’l Corp. v. Voloshin, 366 A.2d 1172 (Conn. Super. Ct. 1976), holding that despite legalization of gambling loans by recent state legislation, the extension of credit to participate in gambling still created an unenforceable loan as against public policy.

\textit{Id.} at 1175; accord Resorts Int’l Hotel, Inc. v. Salomone, 429 A.2d 1078, 1082 (N.J. Super. Ct. App. Div. 1981)(attributing as the underlying policy for the New Jersey legislation that “‘ready, unlimited credit can have a ‘pernicious effect’ upon the compulsive or imprudent player’”).

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sino's violations were deliberate.\textsuperscript{62} As a result, the settlement of the debt might have been on grounds of statutory violation and totally without regard to damages actually suffered by Zarin,\textsuperscript{63} the equivalent of exacting a penalty from the creditor as a condition of collecting the loan. As such, the reduced amount would be includable in income.

A different result might be obtained if the reduction of the debt could be conceptualized as compensatory relief from tortious personal injury of Zarin. A specific provision in the Code excludes personal injury awards from income.\textsuperscript{64} The theory is that such relief results not in a benefit amounting to an accession to wealth, but instead in restitution or tort damages to make the victim whole by restoring the payee tax-free to the same position as that victim would have enjoyed in the absence of the tort.\textsuperscript{65} On the facts of Zarin's case, the most plausible basis for such an award may have been a New Jersey statute or local tort law principles entitling Zarin to liquidated damages to compensate him for a worsened psychological or physical state attributable to the creditor's aggravation of the compulsive condition\textsuperscript{66} (e.g., by harassment or preying on that

\textsuperscript{62}The casino was fined for over 100 violations with respect to Zarin alone. See also 92 T.C. at 1105 (Jacobs, J., dissenting) (observing that the casino "fueled" the debtor's compulsion through the extension of credit).

\textsuperscript{63}See, e.g., \textsc{Restatement (Second) of Torts} § 874A cmt. b (1977) (discussing tort liability for violations of legislation when no civil remedy specified); cf. Comment, \textit{Private Remedies Under the Consumer Fraud Acts: The Judicial Approaches of Statutory Interpretation and Implication}, 67 \textsc{Nw. U. L. Rev.} 413 (1972).

\textsuperscript{64}See I.R.C. § 104(a)(2).

\textsuperscript{65}In fact, however, the specific statutory exclusion extends beyond what is explained by this notion of mere restoration. That is, besides compensation for pain and suffering, disfigurement, and the like, the statutory exclusion for "damages received . . . on account of personal injuries or sickness" literally encompasses recoveries for lost future earnings as well as punitive damages, both of which would be taxable in the absence of this statutory authorization. If a rational explanation rather than historical accident explains this, it is perhaps that if the rule were otherwise, jurors might simply increase the awards commensurately to cover the victims' taxes, as would victims in their bargaining over settlements.

In recent years, the government has sought to deny an exclusion from income for punitive damages and economic losses, at least in cases of personal injuries that do not entail physical injury or sickness. See \textsc{Chirelstein}, supra note 4, ¶ 2.04. The effort has been largely unsuccessful in court. See authorities cited infra note 66. Whereas section 104(a)(2) authorizes an exclusion for amounts received by suit or settlement "on account of personal injuries or sickness," a 1989 statutory amendment to section 104(a) adopts the government's view at least as to punitive damages in cases without physical injury or physical sickness. See I.R.C. § 104(a).

\textsuperscript{66}Numerous recent cases construe the terms "personal injuries or sickness" appearing in section 104(a)(2) to refer to any injuries to the "person" in contrast to injuries to property or losses suffered by contract. As a result, the cases permit exclusion from income of damages received by suit or settlement even in the absence of a physical injury, and even though the damages are measured strictly by economic loss (such as lost wages from discrimination), provided the awards are characterized as compensation for violations of "personal" rights. Burke v. United States, 929 F.2d 1119 (6th Cir. 1991) (back pay under Title VII of the Civil Rights Act of 1964 for sex discrimination), cert. granted, 112 S. Ct. 47 (1991); accord Pistillo v. Commissioner, 912 F.2d 145 (6th Cir. 1990) (age discrimination); Rickel v. Commissioner, 900 F.2d 655 (3rd Cir. 1990) (age discrimination); Thompson v. Commissioner, 866 F.2d 709 (4th Cir. 1989) (gender discrimination); Bent v. Commissioner, 835 F.2d 67 (3rd Cir. 1987) (denial of first amendment rights); Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983) (defamation). Punitive damages, however, can be excluded only if paid incident to a suit or settlement for physical injuries or physical sickness. See \textsc{supra} note 65.

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If a reduction of Zarin's debt was not excluded from income by section 104(a)(2) as a personal injury award, it might nonetheless be outside the definition of income based on principles of contract law applied to Zarin's compulsive condition. That is, Zarin's condition might have so reduced his capacity to contract as to entitle him to rescind the contract, with restitution of $0.5 million all that was required to forestall his own unjust enrichment. Viewed in this way, Zarin did not enjoy any net accession to wealth from cancellation of the $2.935 portion of the debt.

Which of the preceding analyses best characterizes Zarin's settlement depends, according to traditional doctrine, on which rationale local law would assign to explain the award. Federal tax law defers to local law on such matters as the determination of a taxpayer's property and contract rights, and whether an award is for a personal injury or not. (The tax consequences, however, of these determinations are for the tax law to resolve; for reasons examined in Part III, these may prompt an inclusion in Zarin's income regardless of attitudes of local law toward sufferers of compulsive conditions.)

Unlike the facts in Zarin, one of the two cases relied on by the Third Circuit to support its disputed debt doctrine fit the above-described model of which settlements are tax-free. In Sobel, Inc. v. Commissioner, the taxpayer purchased shares of stock on credit and later settled the debt for less than its face value after a contest based on the other party's alleged failure to perform as agreed. This is precisely the sort of case that should avoid COD income. The reduction of the debt did not enrich the debtor. Rather, it more accurately reflected the debtor's obligation once the purchase price was revised to reflect the shortcomings in the other party's performance. Nevertheless, the facts of Zarin do not seem to fit such a characterization. The precedent therefore appears inapposite, notwithstanding the implication to the contrary by the appellate decision in Zarin.


See, e.g., Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983) (characterizing defamation as personal injury by state law); cf. Threlkeld v. Commissioner, 87 T.C. 1294, 1306 (1986) (indicating that when state law is unclear, "we will look to all of the facts and circumstances to determine whether the injury is, in fact, personal").
The other case relied on, *United States v. Hall*, 72 was closer on its facts to *Zarin*, but undermined as a precedent by a later Supreme Court decision. Hall is not a case about settlement of a debt for any reason other than the alleged unenforceability of the debt, a ground that on its own provides no justification for a tax-free benefit to the excused debtor.

To summarize, neither the two cases relied on by the Third Circuit in *Zarin*, nor the fact that the debt in *Zarin* was contested as unenforceable, inexorably warranted the court’s pro-taxpayer result. A correct analysis required inquiry into the reasons for the parties’ settlement. On the basis of *Zarin*’s vulnerable compulsive condition, local contract or tort law principles might have furnished *Zarin* with grounds for damages or partial relief from the debt that in turn would have theoretically warranted exclusion of the canceled portion of the debt from *Zarin*’s income. The record was ambiguous on this score however. (Even if favorable it might not have dictated a pro-taxpayer outcome, for reasons explored in Part III.)

B. No Canceled Debt: Amount Repaid Equal to Debt

Several commentators have reached the same conclusion as did the Third Circuit, about the equality in the size of *Zarin*’s debt and the $0.5 million settlement figure preventing income to *Zarin*, but by a variation in analysis. They reason from the facts themselves rather than from the notion that the good faith dispute transformed the cognizable size of the debt. Their view of the facts is that the settlement payment precisely equalled the size of the canceled debt, 74 on the premise that the debt and chips had a cash equivalent value of $0.5 million, not $3.435 million.

Four supporting lines of reasoning have been advanced:

1) The chips were of restricted utility that depressed their value (e.g., due to their stipulated nonnegotiability, unavailability for use outside of the casino, and the unlikelihood that *Zarin* could cash them in while he had such a large outstanding debt to the casino);

2) The transaction amounted to a bargain purchase of chips by *Zarin* for $0.5 million, as evidenced by the unenforceability of the debt and the expectation that only that reduced amount would be repaid;

3) The furnishing of the chips to *Zarin* was primarily for the benefit of the casino, not *Zarin* (i.e., to encourage gambling patronage by *Zarin* as well as others whom his heavy betting attracted to the gaming tables and stimulated to gamble), and therefore not of a value to *Zarin* equal to the face amount of the chips; and

4) The settlement value of the loan at the time of the consumption/repayment date, rather than earlier, determined the size of the loan.

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72United States v. Hall, 307 F.2d 238 (10th Cir. 1962).
73See Commissioner v. Tufts, 461 U.S. 300 (1983); see also supra text accompanying notes 42–46 (discussing Hall).
74Dodge, supra note 4, at 679–80; Gunn, supra note 4, passim; KAHN, supra note 4, § 2.1295. See *Zarin* v. Commissioner, 916 F.2d 110, 112 (3d Cir. 1990).
Although it is conceivable that the chips and loan extended to Zarin had a mere $0.5 million or perhaps even lesser value, certain of the stipulated facts so seriously undermine this conclusion as to make such an inference unreasonable. Not surprisingly, the Tax Court concluded that the benefit and debt amounted to the full $3.435 million face value.

The fact that Zarin spent $2.5 million of his own funds for chips of an equivalent $2.5 million face value corroborates the $3.435 million face value of the chips and debt. Other gamblers too apparently valued the chips at face value by buying them for cash and using them to cover their bets of like value (a factor that should be significant to this analysis, which rejects subjective valuations based on individual marginal utility curves, including a compulsive gambler's, in favor of objective data of values as set by the market). Another telling stipulation acknowledged that Zarin had incurred a $3.435 million debt, and that he intended to repay it in full even after he had lost that entire amount in gambling. Also, a winning streak by Zarin would have obliged the casino to credit him with full face value for the chips.

Even if $3.435 million overstated the value and size of the debt, Zarin could not prevail in escaping income by simply establishing that the $3.435 million face amount of the debt had some lesser cash equivalent value. To eliminate all possibility of income would have required valuing the chips at the settlement figure of $0.5 million—85% below their stated worth!

The stipulated facts require more than a (compulsive gambler's) leap of faith to conclude that Zarin borrowed no more than $0.5 million. Although the chips were of restricted use, presumably they could have been sold to other patrons of the casino at a price well in excess of an 85% discount. Nor does the record suggest that only $0.5 million would be repaid. Zarin had an excellent history of honoring his debts with the casino; nothing indicated that he had reached a

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75 Zarin, 92 T.C. at 1092, 1094, 1096.
76 The Tax Court bolstered its conclusion of a $3.435 million debt by adding that in theory Zarin could have cashed in the chips for the full $3.435 million figure. This point, however, is a weak one. As others have noted, including the Third Circuit in Zarin, the right to cash in the chips was more theoretical than real; New Jersey law required repayment of the offsetting debt to the casino as a condition to cashing in the chips. 916 F.2d at 114. Furthermore, if the debt and chips could be used solely for gambling, it begs the question to assign a $3.435 million value to the debt on the ground that the full debt could be extinguished by turning in chips having a like $3.435 face value. Likewise, if Zarin had no intention of paying off the debt when he incurred it, it begs the question to reason, as did one dissenting Tax Court judge, on the authority of James v. United States, 366 U.S. 213 (1961), for income to Zarin at the initial date of the loan rather than later, on the basis of his lack of a consensual obligation from the outset to repay a full $3.435 million. The conclusion is only correct if Zarin in fact borrowed $3.435 million.

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77 92 T.C. at 1086-87, 1088, 1092.
78 916 F.2d at 112. This may have been due to side advances of as much as $10 million from another individual. See Nemtin v. Zarin, 577 F.Supp. 1135 (D.N.J. 1983). But see Gunn, supra note 4, at 894 ("[I]t is reasonable to suppose that the casino employees who extended so much credit to Zarin knew that the casino was unlikely to be able to recover the full amount." (emphasis added)). See also Dodge, supra note 4, at 683 (unenforceability reinforces conclusion of receipt of less than $3.435 million). Neither authority explains why it is reasonable to infer that only $0.5 million or less would be repaid.
state of inability to repay more than $0.5 million or of a willingness to risk exclusion from the casino for not repaying.

The casino's own actions do not support an inference that it was willing to allow Zarin $3.435 million of chips for only $0.5 million, either as a bargain purchase or to act as a surrogate shill. Its actions in cutting off Zarin's credit, filing a lawsuit to collect the $3.435 million, and its eventual agreement to a settlement price of $0.5 million only after the suit was contested, all imply the contrary. The casino's eventual acceptance of $0.5 million is evidence of settlement value only, not the amount of the debt. Its acceptance might have reflected a fear of adverse publicity, of litigation expenses, or a risk of even a lesser recovery were collection any further delayed, all without in any way indicating anything about the actual size of the debt.

Some commentators who take the position that the figure at the date of settlement/consumption is the appropriate measure of the debt do so explicitly on policy grounds, and not on the premise that such doctrine has support in existing substantive law. As its proponents suggest, a principle that fixes the size of a debt for tax purposes by the amount actually repaid could serve the goal of taxing according to ability to pay. The logical thrust of such a rule, however, seems troublingly unbounded. Unless limited in application to cases of special facts (such as Zarin's compulsive condition), such a rule could emasculate the imposition of COD income whenever a consumer's credit transaction (e.g., purchase of a stove on credit) is repaid at less than the original debt, regardless of that consumer's ability to pay the full debt.

True, the measure of value taken account of for tax purposes is frequently the amount that a taxpayer eventually agrees to and does in fact pay. The discussion above on settlements of debts illustrates this. Furthermore, tax-free promotion samples, employer-provided goods and services, and benefits furnished free

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79See Dodge, supra note 4, at 682-83, 688; Gunn, supra note 4, at 894-95; Kahn, supra note 4, § 2.1295; cf. Shaviro, supra note 4 (expected cost analysis); Chirelstein, supra note 4, at 57 (presumed informal understanding), quoted in note 6 supra.

80See the explicit concession to this effect by Kahn, supra note 4, §§ 2.1290, 2.1297-2.

81See Gunn, supra note 4, at 894-95; accord Dodge, supra note 4, at 681-82; Chirelstein, supra note 4, at 57 (by implication), quoted in note 6 supra.

82Dodge, supra note 4, at 695, implies that Zarin's debt can be distinguished from other canceled consumer debts as being a loan primarily of value to the casino from which Zarin derived only restricted command or control over the funds. But see infra text in paragraph following note 86. Counsel for Zarin suggested that Zarin's gambling debt was of a special nature because it cost the creditor nothing of tangible value to provide him with the opportunity to gamble. 92 T.C. at 1099. If true, this would distinguish his debt from debt-financed purchases of consumer durables, and similar items. But is the distinction valid? What if Zarin had won instead of lost? What if all losing gamblers took the same position?

83Just such an example was presented in the dissenting opinion of Zarin on appeal, as one of the grounds of Judge Stapleton's concern about the pro-taxpayer result reached by the majority. See 916 F.2d at 117 n.1 (Stapleton, J., dissenting).

84Haverly v. United States, 513 F. 2d 224 (7th Cir. 1975).

85See, e.g., I.R.C. § 119 (excluding from an employee's reportable income the meals and lodging furnished for the employer's convenience).
or at a below-list bargain price,\textsuperscript{86} all demonstrate that ostensible fair market values may at times be ignored for tax purposes and replaced with what the taxpayer agreed to pay.

None of the situations noted in the preceding paragraph, however, seems a pertinent precedent to justify disregarding the agreed-upon value of Zarin's debt as the relevant figure for tax purposes. In those contexts there is no reason on the facts to believe that the consumer would ever have paid an objectively determined market value, hence no reason to conclude that an accession to wealth occurred as a result of paying a lesser figure. The same was not true of Zarin. He stipulated to a $3.435 million figure for his loan.

In sum, the otherwise unsupported assertion that the size of Zarin's debt equalled its $0.5 million settlement value appears to be a result-oriented pronouncement advanced on the basis of Zarin's acknowledged compulsive condition.\textsuperscript{87} Nothing else in the record or in established legal doctrine would justify a reduction of his debt tax-free to the $0.5 million figure. If so, this point in support of Zarin collapses into the argument examined in the preceding section, and once again invokes an inquiry into whether a compulsive condition should justify elimination of income upon cancellation of a debt.

C. Ability to Offset (Gambling) Losses Against Interrelated Income

The third theory in support of tax relief for Zarin postulates that all income and losses from any single integrated transaction should be netted together, and Zarin's gambling losses should therefore be offset against any income generated by the canceled debt. The theory obviously assumes that Zarin's losses and the cancellation of the debt were so interrelated as to warrant characterizing them as an integrated transaction.

Two commentators treated as self-evident the idea that a single integrated transaction bound the canceled debt to the gambling losses.\textsuperscript{88} A third, Professor Kahn, had this to say:

The taxpayer's gambling can be viewed as a service provided by the Hotel, . . . which was the exclusive object to which the credit could be applied. On a transactional approach, the settlement of taxpayer's debt for a lesser figure can be viewed as a reduction of the cost of the gambling service or as a reduction of taxpayer's gambling losses. In other words, the credit accorded taxpayer was so inextricably attached to the gambling activity that the cancellation of part of that debt cannot properly be treated as an event isolated from the gambling itself.\textsuperscript{89}

Under this view, the very fact that the debt was for purposes of gambling or

\textsuperscript{86}See, e.g., I.R.C. § 132; United States v. Gotcher, 401 F.2d 118 (5th Cir. 1968).
\textsuperscript{87}Compare Prof. Chirelstein's related proposal, as set forth supra note 6. Chirelstein acknowledges that his pro-Zarin view is predicated on Zarin's compulsion and suggests that this be accommodated by a special rule for cases that he identifies as "any sizeable debt [of a] heavy loser." CHIRELSTEIN, supra note 4, at 57, quoted in note 6 supra.
\textsuperscript{88}Dodge, supra note 4, at 678, 687; Johnson, supra note 4, at 701-03.
\textsuperscript{89}Kahn, supra note 4, at 61-62.

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determined by gambling losses suffices to provide the necessary link for an integrated transaction analysis to apply. It warrants the events being pooled as a unit, without regard to causal connections or intervening forces. That is, this approach seems to make irrelevant what actual factors explain why the debt was not fully repaid (in Zarin’s case, apparently because of Zarin’s contest of the creditor’s lawsuit), or that the settlement might have occurred even if a winning streak by Zarin had replenished his losses and the chips with which to repay the debt.

Obviously there was some relationship between the gambling losses and the discharged debt. For one thing, the $2.935 million canceled amount grew out of a debt run up by Zarin through gambling losses. Second, the losses were incurred in betting chips that were the very proceeds of the loan. Despite this connection, neither these nor other facts inextricably link the gambling losses and canceled debt.

One obstacle in unifying the debt and the gambling losses is the theoretical difficulty of tracing particular expenditures (e.g., gambling losses) to specific loan proceeds, even when those precise proceeds—here, chips—are adequately segregated and tracked from the date of the loan. Whether Zarin borrowed from the casino for gambling and so freed his cash and other assets for other uses, or instead used his own resources for gambling and borrowed for other uses, the happenstance of the borrowing and application of the loan proceeds should not lead to disparate conclusions as to how the loan proceeds were used in the two scenarios.\(^9\)

Second, even if the loan did finance the gambling losses, its cancellation may have represented a windfall accession to wealth, unrelated to the losses. If so, the resulting COD income should not be offset on the theory that the entire transaction funded by the loan proved to be a loss. An old Supreme Court decision\(^9\) excused the debtor from COD income on that theory. The case, however, is now generally discredited\(^9\) by case law and critics alike.\(^9\)

\(^9\) Only in an extreme case of a debtor with no other assets, who is able to secure a loan for one marginal purpose only, can the use of loan proceeds be validly traced. Recent debates over whether interest on a loan should be regarded as incurred in a business or personal transaction massage this concept in detail for those who are interested. See, e.g., Cheryl D. Block, The Trouble With Interest: Reflections on Interest Deductions after the Tax Reform Act of 1986, 40 U. FLA. L. REV. 689 (1988).


\(^9\) See Zarin v. Commissioner, 92 T.C. 1084, 1093-94 (1989), rev’d on other grounds, 916 F.2d 110 (3d Cir. 1990); accord Dodge, supra note 4, at 678 (“Bowers v. Kerbaugh-Empire Co., which allowed debt-cancellation income to be excluded on the ground that such income was less than the loss on the transaction funded by the borrowed money, is no longer good law.”) (footnotes omitted).

\(^9\) See Bittker & Thompson, Jr., supra note 15, at 1162-1163, additionally criticizing Kerbaugh-Empire Co. on the ground that to permit a deduction for the losses on the theory that the transaction as a whole in which the borrowed funds were used turned out to be unprofitable could amount to double counting of those losses and a consequent unwarranted tax savings. That is, double counting of the losses could result if an expenditure that was funded by the loan were to create an offset against income in the form of a business or profit-seeking expense, and a second deduction for a loss on grounds that the activity proved inadequately profitable to cover those expenditures. In Zarin’s case, however, there was no such problem of double counting; the losses reflected in the canceled portion of the debt were those that exceeded gambling winnings and that, therefore,
Nor should cancellation of the debt at a discount, out of the creditor’s concern that gambling losses would render the debtor unable to repay more in the future, suffice to permit integration of the losses with the canceled debt. To conclude otherwise would be counter to the directive implicit in the Supreme Court decision that approved the levy of COD income on an economically troubled debtor.\textsuperscript{94}

Likewise, reduction of the debt as a payment mechanism for obligations of the creditor that arose wholly independently from the size or occurrence of gambling losses should not qualify the canceled debt and losses as a transactional unit. For example, punitive damages may have been owing to Zarin for the casino’s credit violations. If so, their payment should be equally taxable to Zarin whether discharged by debt reduction or by cash damages to Zarin. The chosen method of payment should not produce disparate tax results.

If the single transaction doctrine is to justify pooling COD income and gambling losses, it should do so only when the two amounts are functionally interdependent—causally connected if you will—due to the creditor’s responsibility for those very losses. A loan itself should not suffice to burden the creditor with losses suffered by the debtor in the activity funded by the loan. For example, consider the nonresponsibility of a creditor for the losses suffered by a debtor who, after purchasing a train ticket on credit, and while standing on the station platform waiting for a train to Rockaway Beach . . . \textsuperscript{95}

The sort of facts that would seem to link gambling losses and income from a canceled debt, and perhaps therefore warrant netting the two as components of a single transaction, are those indicative of responsibility on the part of the creditor for having supplied loaded dice, or having facilitated compulsive gambling losses by extending credit in an improper or tortious manner. On the facts as reported in Zarin, Zarin’s compulsive condition seems the most likely fulcrum for holding the casino liable for his losses. For one thing, the New Jersey law repeatedly violated by the casino,\textsuperscript{96} which required casinos promptly to cash gamblers’ notes and checks, might be construed as shifting responsibility to the casino-creditor for gambling losses suffered by an over-extended (read, “compulsive”) gambler. Furthermore, just as a credit sale of drugs or liquor to an addict that materializes in foreseeable harm could impose liability on the creditor supplier,\textsuperscript{97} so might the casino bear responsibility for furnishing credit to the compulsive gambler that culminated in clearly foreseeable gambling losses.

Had Zarin’s facts proved to be congenial to an integrated transaction analysis, they faced still a further impediment, in the form of section 165(d), relevant to pooling income from the canceled debt with the gambling losses. That section necessarily had not produced any earlier tax benefit in view of the statutory limitation of section 165(d). See infra text accompanying notes 95-109 (discussing section 165(d)).

\textsuperscript{94}See United States v. Kirby Lumber, 284 U.S. 1 (1931), discussed in Bittker & Thompson, Jr., supra note 15, at 1163-64.

\textsuperscript{95}See Palsgraf v. Long Island R.R., 162 N.E. 99 (N.Y. 1928) (defendant’s wrong to a third party, which results in physical injury to plaintiff, who is a customer of the defendant’s, is not an actionable wrong to plaintiff).

\textsuperscript{96}See supra note 30 (quoting the applicable New Jersey law).

\textsuperscript{97}See generally 3 Fowler V. Harper et al., The Law of Torts § 16.12 (2d ed. 1986).

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appears to restrict gambling losses from being deducted or offset against anything but winning bets.

According to section 165(d): "Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." These are words of limitation.99 The scant legislative history of the provision suggests that the statutory reference to "gains from such transactions" was to winning bets and not to other income related to gambling.100 Perhaps the unspoken rationale was that gambling contains a large component of self-entertainment value, and so, like other costs of entertainment, its losses should not serve to offset and reduce reportable income—except to the extent of winning bets which can themselves be thought of as directly decreasing the very cost of gambling.101 Under this rationale, gambling losses could not be offset against other than winning bets, regardless of whether the other income was from an integrated transaction, or whether by nature it was COD income, compensation for interviews about Zarin's gambling experiences, or for lessons about how (not) to gamble.102

A second possible obstacle to utilizing the gambling losses as an offset even if the integrated transaction analysis were to apply is that the losses arose in a separate tax year from the one in which the cancellation of the debt occurred. Congress may well have intended gambling losses to be utilized, if at all, only in the year when incurred. Legislative history so indicates.103 So does case law in preventing losses incurred in a business of gambling from being carried forward and applied against future income.104

A solution to this potential complication of staggered tax years might be found in the so-called "tax benefit rule."106 According to one aspect of that rule, if

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99 I.R.C. § 165(d).
100 This is implicit from the fact that section 165(a) authorizes deductions for losses, whereas the ensuing subsections (b) through (d) limit that authorization. Subsection (b) limits deductible losses to a claimant's basis. Subsection (c) limits individuals to deductions of those losses incurred in specified contexts: business, profit-seeking activities, or casualty circumstances; and by implication, even in the first two contexts, section 165(d) further precludes the deduction of gambling losses except to the extent of successful wagers. Although section 183 permits the expenses of a hobby to be deducted up to the amount of income from that activity, that section does not authorize gambling losses from an activity that constitutes a hobby to be deducted against anything other than gambling winnings. Just as in the case of a business or income producing activity, the gambling losses should remain disallowed except to the extent of gambling winnings, regardless of the context in which incurred.
102 Cf. Shaviro, supra note 4, at 230-235.
103 See Jacoby v. Commissioner, 29 T.C.M. (CCH) 1068, T.C.M. (P-H) ¶ 70.244 (1970) (bridge expert's income from bridge instruction not sheltered by gambling losses). A number of cases construe the phrase "gains from wagering transactions" in the narrow sense of meaning winning bets. They therefore refuse to permit gambling losses to be offset against other income arising from a gambling activity. Boyd v. United States, 762 F.2d 1369 (9th Cir. 1985) (denying compensation income the characterization of wagering gains); accord Williams v. Commissioner, 41 T.C.M. (CCH) 312, T.C.M. (P-H) ¶ 80,212 (1980) (tips received by blackjack dealers).
104 See S. REP. No. 830, 88th Cong., 2d Sess. 142 (1964); see also Regs. § 1.165-10 (1960).
105 See, e.g., Commissioner v. Groetzinger, 480 U.S. 23 (1987) (holding that gambling can be a business for income tax purposes).
106 See Offutt v. Commissioner, 16 T.C. 1214 (1951).
107 See I.R.C. § 111.
deductible expenses are incurred without producing any current benefit in the
form of tax savings, they can be applied against income recognized in a later
year from that very same transaction. At least one commentator has taken the
position that application of the tax benefit rule would justify applying Zarin's
formerly authorized but unused gambling loss deductions against his eventual
income from the canceled debt, on the premise that the income and the losses
were part of an integrated transaction.

Perhaps in the limited circumstances of an integrated transaction, the tax
benefit rule prevails over the aforementioned proscription against use of gambling
losses from one year as a reduction of income from a later year. That is, the
ban against carryover of gambling losses might not apply to a single, integrated
gambling session in which pre-midnight losses from one year are followed by
winnings in the early hours of the following year. In unintegrated circumstances,
however, the clear legislative plan against carrying over gambling losses ought
not to be defeated by permitting an earlier year's losses to be claimed as an
offset under the banner of a tax benefit theory.

What seems clear from the foregoing discussion is that to net Zarin's gambling
losses against income, if any, from his canceled debt requires at a minimum the
interdependence of the two—that is, with the release of the debt explained by
the creditor's responsibility for the losses that comprised that debt. On the facts
of Zarin, the gambler's compulsive condition seems the best hope to providing
the necessary link. It furnishes the most plausible explanation as to why the
creditor might have been responsible for absorbing Zarin's gambling losses.
Whether compulsive conditions such as Zarin's, should provide adequate grounds
for tax relief under the label of the integrated transaction doctrine is a severable
question, discussed below in Part III.

This is not to say that Zarin should have reported income if the integrated
transaction analysis were inapposite, or if section 165(d) limited the netting of
his gambling losses strictly together with income from winning bets or with
income arising within the same tax year. After all, it is possible that release
from the debt was not itself an income producing accession to wealth. This might
be so due to reasons discussed earlier about compensatory, personal damages
for such torts not constituting income, or because of the tax-free "return of
capital" doctrine, which acknowledges that recoupment of one's own property
stolen by crooked dice is not an accession to wealth. The immediately suc-
ceeding paragraphs of Part II.D. offer additional reasons.

D. Losses from Compulsive Conduct Dispel the Benefit or Consumption
Value Essential to a Measurement of Income

The fourth theory for relieving Zarin from COD income explicitly takes ac-
count of his compulsive condition. It treats the canceled debt as amounting to

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107 See KAHN, supra note 4, § 2.1280.
108 See Johnson, supra note 4, passim.
109 See supra text accompanying notes 63-66.
110 See Dobson v. Commissioner, 320 U.S. 489 (1943); Clark v. Commissioner, 40 B.T.A. 333
(1939), nonacq., 1939-2 C.B. 45.

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an objectively determined $3.435 million value, but denies this to be the value to Zarin due to his compulsive condition.

Predecessors to this line of analysis can be found in the earlier discussed decision of United States v. Hall.111 The canceled debt at issue in Hall had been taken out to cover gambling losses already incurred by the taxpayer at an earlier time. The court in Hall reasoned that the taxpayer derived no benefit, and hence no income, either from incurring such a debt or from its cancellation (a conclusion criticized earlier in this article).112

In Zarin, the Tax Court’s dissenters expressed disbelief that paralleled the concerns evidenced in Hall on whether a gambler benefits from debts to cover gambling losses. They pointed to the paradoxical result if the cancellation of Zarin’s debt were to be treated as causing him income. In Judge Tannewald’s words:

The concept that petitioner received his money’s worth from the enjoyment of using the chips (thus equating the pleasure of gambling with increase in wealth) produces the incongruous result that the more a gambler loses, the greater his pleasure and the larger the increase in his wealth.113

Judges Jacob and Ruwe expressed a similar theme in their dissenting opinions.114

The fact is, however, that a similar incongruity tends to take shape whenever losses suffered by a debtor motivate the creditor to excuse the debtor’s obligation. The greater the debtor’s losses, the more eager the creditor to settle, and at an ever deeper discount. The size of the canceled debt therefore bears a positive correlation to increased losses of the debtor. A less than economically-thriving debtor seems the most likely candidate of COD income. As was noted in the leading article on debt cancellation,115 such a debtor may well have been the taxpayer even in the Supreme Court decision116 that initiated the doctrine of COD income.

The unique feature in Zarin’s case was his compulsive condition which, he argued, made his losses inevitable:

Petitioner argues that he did not get anything of value when he received the chips other than the “opportunity to gamble,” and that, by reason of his addiction to gambling, he was destined to lose everything that he temporarily received.

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111307 F.2d 238 (10th Cir. 1962).
112See supra text accompanying notes 43-45.
113Zarin, 92 T.C. at 1100-01 (Tannewald, J., dissenting) (footnotes omitted).
114Judge Jacob described the opinion of the majority in the Tax Court as “tantamount to taxing the petitioner on his losses.” Id. at 1107 (Jacob, J., dissenting). Judge Ruwe observed that it seems “ironic [to impose] a huge tax liability, the magnitude of which is in direct proportion to [Zarin’s] losses.” Id. at 1115-16 (Ruhe, J., dissenting).
115Bittker & Thompson, Jr., supra note 15, at 1163-64; see also L. Hart Wright, Realization of Income Through Cancellations, Modifications, and Bargain Purchases of Indebtedness: I, 49 Mich. L. Rev. 459, 477 (1951) (“[I]t is safe to assume that the most frequently recurring opportunities for bargain discharges . . . present themselves to debtors whose financial condition is in jeopardy.”).
Thus, he is in effect arguing . . . that the settlement merely reduced the amount of his loss and did not result in income.117

The relevance of compulsiveness to the concept of income blossomed to a full-blown theory in Professor Shaviro's groundbreaking article.118 Shaviro analyzed Zarin's entitlement to relief by reasoning from the notion of income embodied in the "Haig-Simons" definition119 that is generally acknowledged to express the fundamental precepts of income underlying our federal income tax. According to this definition, as paraphrased by Shaviro, "Income is the market value of the taxpayer's consumption and change in net worth during the relevant accounting period."120 With this as his linchpin, Shaviro theorized that income (including COD income) presupposes some positive consumption value to the taxpayer, whereas for a compulsive actor such as Zarin, the negative utility value in acting out a compulsive urge balances out the positive value essential as a predicate for income.

If others share Professor Shaviro's observations, they have not yet declared themselves121—apart from Mr. Zarin, that is. Nonsympathizers point out some apparently insurmountable problems of attempting to measure the value of compulsive behavior subjectively, either for that actor alone or by reference to personal marginal utility curves of other persons.122 They differ from each other and from Professor Shaviro over the possibility of the gambling losses themselves being of positive value,123 and increasingly so as losses mounted over time.124

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117Zarin, 92 T.C. at 1092.
118Shaviro, supra note 4.
120Shaviro, supra note 4, at 222.
121For example, none of the other eighteen Tax Court judges concurred in whole or in part in Judge Tannewald's dissent. Within the professorial community, a few of the commentators on Zarin have publicly identified with views of one another, but not with Professor Shaviro's. See authorities cited supra note 4. Professor Chirelstein comes close to agreement. See CHIRELSTEIN, supra note 4. So does this author; I strongly sympathize with Shaviro's views as to why, under the tax system, special consideration may be due to certain compulsive actors, but in the end believe it best to work these tax matters out by federal legislation rather than judicially as in Zarin. See infra Part III.
122See Dodge, supra note 4, at 681, 688-89; Gunn, supra note 4, at 894; Johnson, supra note 4, at 700. See, for example, on this score, Professor Newman's tongue-in-cheek account of his youthful addiction to Red Hots (red cinnamon candy beans); the more he ate, the more he needed in order to achieve the same thrilling explosion of red-hot flavor. Newman, supra note 4, passim. His brief report is an allegorical treasure, at least on this author's marginal utility curve.
123Some assume that no gambler derives any benefit or value from losses (not even the guilt-driven seeker of punishment?). Others assume that the experience of gambling, including the opportunity to win, may have positive value even while losses concurrently build. But cf. Stephen D.D. Hamilton, Third Circuit's Contingent Liability Theory Produces Correct Result in Gambling Debt Discharge, 50 TAX NOTES 409, 410 (Jan. 28, 1991) (reasoning that the value of the opportunity to gamble declines as time passes because "[t]he more bets you make when the odds are against you, the lower your percentage chances of coming out ahead over all").
124For example, in response to Judge Tannewald's observation, supra text accompanying text at note 111, that it would be ironic if greater losses translated into greater income, Professor Gunn countered that this view appears to contain a self-contradictory flaw—the gambler with greater losses
The irony is that some of the critics' own doctrines are what demand rigorous valuations, not Professor Shaviro's as he posited it. Any insistence on objective valuations, albeit according to "market," of what a willing (noncompulsive) buyer would have been willing to pay, is not a self-executing guide to the appropriate amount of value.\(^\text{125}\)

Professor Shaviro finesses the valuation problems. Most of his analysis suggests that a compulsive gambler becomes entrapped in an internally contradictory experience of agonizing ecstasy, with a presumed negative value automatically adequate to balance the positive values therefrom. (Ultimately, however, out of administrative considerations, Shaviro proposes the assignment of an artificial value exactly equal to the amount for which the debt is settled.)\(^\text{126}\)

In large part the methodology employed by Shaviro is quite traditional, notwithstanding its deference to subjective considerations and its endorsement of artificial values in displacement of objectively measured market values. An inquiry into the realm of motivation is a common exercise in the tax field in gauging the status of a payment as income. For example, the payor's motivation is in theory what determines whether a payment is compensation or can instead be excluded from the payee's income as either: a nontaxable gift,\(^\text{127}\) a nontaxable condition of employment (e.g., meals and lodging furnished primarily for the convenience of the employer in assuring job performance),\(^\text{128}\) or a tax-free fringe benefit.\(^\text{129}\) Objective factors help inform the conclusion, but the test is ultimately one of subjective intent or motivation.

Shaviro further follows in the path of tradition by not attempting to measure precisely how much personal benefit the taxpayer derived. He rejects the presence of reportable income attributable to personal benefit, just as do the cases in the absence of legislative guidance\(^\text{130}\) in determining whether there is income when must have gambled the longer and so enjoyed greater value. Gunn, supra note 4, at 894. (Gunn's observation about relative time spent gambling seems an accurate assumption, given house limits on the size of bets and an assumption that compulsive gamblers always bet the maximum. Is it necessarily true, however, that the longer the gambling period, even a losing one, the greater the benefit or value derived? See supra note 123.)

Critics who were willing to excuse Zarin from income by application of theories numbered 1 through 3, see supra text accompanying note 74, also did not have to address the determination of market value, for their theories assumed that the amount of the canceled debt automatically equalled what the debtor paid in settlement. The same expediency, however, is unavailable to resolve the tax consequences in a case in which a compulsive gambler/drinker receives compensation in kind in the form of the abused substance. How is the value of income there to be calculated?

Shaviro, supra note 4, at 251.

See generally Commissioner v. Kowalski, 434 U.S. 77 (1977) (giving detailed analysis of the convenience of employer rationale for excluding from an employee's gross income benefits primarily conferred other than as compensation by the employer).

Id. Similarly, the subjective factor of the primary purpose of the payor also enters as a determinative factor in distinguishing between payments that qualify as tax deductible, because made for the primary purpose of income or business production, rather than for the primary purpose of personal benefit. Compare I.R.C. §§ 162 and 212 (deductions for business and income-producing expenses) with I.R.C. § 262 (nondeductibility of personal living expenses).

Cf. I.R.C. § 119(d) (employing a statutory formula for determining what portion of the value

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the convenience or self-interest of the provider-payor predominates to explain why a benefit was provided.

Other features of Shaviro's approach, however, are unconventional, and critically so. He applies this special treatment to circumstances in which the benefits from compulsive behavior are wholly independent of any return to other actors. This is not an instance in which a provider of the benefit derives a concurrent self-serving return, as illustrated by promotion samples and goods provided, in tax jargon, for the convenience of employer. In those instances the benefit may have been for the provider only, thus justifying the recipient in ignoring the possibility of some concurrent personal utility value. In Zarin's case, however, no external factor exists to rule out the inference that the canceled portion of the debt represents an accession to the debtor's wealth. Traditionally, absent a showing that the interest of the provider/employer/creditor predominates as an explanation for the below-market charge, the inference of an accession to wealth converts the amount to taxable compensation or windfall.

Shaviro instead allows the actor's own compulsive condition to trump any personal, cognizable value and thereby to justify ignoring any accession to wealth. He reasons on the basis of a presumed negative value to the compulsive experience. This of itself is treated as adequate to counterbalance or outweigh the actor's personal utility value from the behavior—a presumption that emanates from an undocumented assertion rather than any wellspring of human experience based on life in all its fullness from which a lay person can objectively corroborate or reject the presumption. Others may be inclined to weight the opposing forces differently, perhaps depending upon the acuteness or the type of compulsive condition (i.e., with different outcomes for binges on food, credit card purchases, alcohol, drugs). At the least, a lay person might wish evidence from experts on the strength of and rewards from the errant behavior, and without this recourse to experts necessarily opening the door to the administrative quagmire of precise valuations and interpersonal comparisons that some critics fear.

The logic of the reasoning calls for disregarding other forms of income, such as compensation in kind, when furnished to a recipient whose compulsive con-
dition entails both positive and negative reactions from consumption of that very in kind payment. For example, liquor paid in kind to an alcoholic would take on a zero value under this thesis, as would drugs to an addict, chips to a compulsive gambler, or food to a bulimic (or perhaps even compensation to a workaholic). Indeed, the person whose income is in kind and consumed directly is probably in greater need of special tax relief than the one who borrows to spend on a compulsion or addiction and then faces COD income upon failure to repay the debt. The latter is at least permitted escape from income when the debt is canceled if she or he is then insolvent or a bankrupt debtor; no parallel statutory escape exists to shelter the insolvent or bankrupt recipient of compensation in kind.

If compensation in kind is encompassed by the theory, then what of cash compensation paid to a compulsive or addict, when the embezzled or stolen funds, or proceeds are destined immediately to be spent on and converted to the abusive experience or substance just as soon as a supplier can be found? True, the tax law more readily finds income present when proceeds are in the form of cash rather than in kind benefits. Cash payments, however, are not inevitably includable in income if there is good reason to believe that the funds (e.g., meal allowances and supper money) did not furnish a cash-equivalent benefit to the payee, but were substantially more akin to a benefit paid in kind.

Moreover, if compensation and other income could be eliminated from the tax base on the grounds of the recipient’s compulsive consumption, allowances for expenditures by a taxpayer in servicing the compulsion or addiction would seem to follow on grounds of logic and parity. True, the one seeking a deduction may have chosen to spend something on the aberrant condition, unlike an individual who merely receives payments in kind of the abused substance itself. Nevertheless, the preceding paragraph suggests this to be a distinction without a difference for a compulsive or addicted personality.

If deductions were thus extended out of compassion and a desire for symmetry of tax treatment, would deductions extend in full to the recovering addict’s expenditures on medicines to cope with the havoc worked by the addiction—expensive drugs to cope with emphysema by the nicotine addicted; drugs to cut down on withdrawal symptoms from liquor or narcotics? The equitable appeal for parity in such cases seems compelling indeed, and yet contradictory of the very legislated restrictions Congress has enacted on deductibility of such expenses (e.g., deductibility of medical expenses limited to itemizers, and subject to a 7.5% floor of automatic disallowance). Can these simply be ignored by the judiciary?

Shaviro acknowledges (without illustrating) the difficult administrative line-drawing considerations posed by his thesis and, in deference to those difficulties,
concludes that tax relief from COD income should be confined to those who settle at a figure that they contemplated might be the settlement price at the opening date of the contract. His ex ante test excludes from the protected class those who had no advance reason for believing that their debts would be compromised.

The concession seems unfortunate to this author. For one thing, this restated version of Shaviro’s thesis fails even to cover Zarin’s case; according to the stipulations, at the time Zarin entered into the debt he intended and expected to repay it in full. It also seems odd, to say the least, to grant relief to an actor with unclean hands who secretly harbored the knowledge that he could not be compelled to repay in full, while denying any special consideration to the individual who, perhaps like Zarin, was too consumed with the addiction or compulsion to consider whether the debt might be unenforceable. Finally, and most importantly, the restated version appears to trivialize Shaviro’s whole line of reasoning. If a settlement of the debt at a lower figure was contemplated by both parties from the start, the debtor could rely on the notion underlying theory B discussed above, to wit, that the settlement price was not an accession to wealth but a mere tax-free reformation to the parties’ original intent.

Obviously, Professor Shaviro’s proposal is only one of a range of responses possible if a taxpayer’s compulsive condition is to culminate in judicial relief. The line-drawing considerations and other problems implicated by any such decisions are the focus of the next Part.

III. THE CASE AGAINST ZARIN

To this point, the discussion was meant to indicate that several logically plausible arguments based on established tax doctrine might be applied to support tax relief for someone suffering from a compulsive condition. A willing judiciary might employ special valuations or other accommodations to the compulsive condition so as to limit the compulsive actor’s measurable income. So might contract or tort principles of local law be used to influence the tax law’s evaluation of whether the litigant enjoyed an accession to wealth and hence income.

Whether the judiciary should be influenced either directly or indirectly in a tax case by a litigant’s compulsive condition, in the absence of guidance from Congress on the matter, raises a wholly different question. The appropriate answer could vary according to a number of factors, including:

1) The response of local law to the condition. As discussed earlier, the characterization by local law of a payment or relief from debt traditionally determines

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141The theories designated A through C in Part II of this article offer one response; no COD income to any degree. Professor Shaviro’s proposal is on the one hand somewhat less indulgent, by excusing such income only if it appeared ex ante that the debt might not have to be repaid in full, yet on the other hand perhaps more indulgent in potentially justifying relief for other forms of income besides that from cancellation of debt. Professor Chirelstein’s proposal, excerpted supra note 4, is of still another order, sometimes more and sometimes less exculpatory depending upon the size of the losses.

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whether for tax purposes the amount constitutes a taxable accession to wealth versus a tax-free restoration of status designed merely to make the recipient whole. The contrast between punitive damages and compensatory payments for injury to person is one illustration. The same could hold true if a compulsive condition were central to the outcome under local law. To allow compulsive conditions to affect tax outcomes in this way would not represent a break in tax tradition.

2) The scope of tax relief at issue. Under a selective approach, judicial accommodations to the compulsive actor's condition might vary as a function of the precise tax relief sought. For example, adjustments to the size of the tax base, via exclusions from income or allowances of deductions, might be less generously granted to the compulsive actor than relief from tax penalties, for example, for underreporting of income or failing to file a return or conferral of a right to defer payment of taxes. In taking action on relief measures, Congress has specifically authorized the judiciary to make facts and circumstances analyses, including consideration of the willful or negligent state of the taxpayer's mind. To grant such dispensations would not be nearly as threatening to the size of tax revenues as would deliberate judicial accommodations in computing the size of the taxpayer's tax base.

3) The nature or severity of the compulsive condition. As the reported reactions to Zarin suggest, instinctively greater judicial sympathy may be aroused by some forms of affliction than others, particularly by human conditions that appear beyond an actor's own control or beyond the experiences of those who are not similarly afflicted. Less sympathy might be paid to conditions that seem to vary less in kind than in degree from what motivates the unafflicted. Thus, sufferers of eating disorders, workaholics, or purchasers on credit who are plagued by a compulsive or a manic personality may arouse less sympathy than those whose compulsions take the form of gambling or drug addiction. Distinctions might also turn on the severity of the symptoms, including the presence of physical addiction or other maladies. Accommodations might also be made a function of the particular form of mental condition or aberration and public attitudes toward it, or a lay person's ability to identify it, without causing taxpayers at large to feel that the accommodations undermined the equity of the system.

Certainly these and other considerations—such as the size of a compulsive

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142 See supra text accompanying notes 56-67.
144 I.R.C. §§ 6651, 7203.
145 See I.R.C. § 6159.
gambler’s losses—could influence the results of tax cases. Yet strong countervailing considerations argue for judicial restraint.

One trouble in deferring to local law’s dogma on the legal impact of compulsive and other mental conditions is its enormous potential for exacting costly tolls in terms of foregone tax revenues. For example, one leading case granted relief from an apparently binding contract entered into by an individual whose psychological impediment prevented her rational decision-making, but without this mental condition being evident to the other party to the contract. Such a decision harbors a clear potential for blurring distinctions between taxable windfalls or taxable cancellation of debt on the one hand, and nontaxable rescissions or recompense of loss on the other. Other courts may be hesitant to follow this lead, given its inevitable toll on the virtues of certainty of contract and consequent willingness of parties to contract, yet their own emerging developments in the tort field could introduce parallel tolls on the Treasury.

See the proposal along this line by Professor Chirelstein, quoted supra note 6.

Although the sciences of psychology and psychiatry have developed mainly in the last half century, the test for incapacity to contract has remained the same since 1895 and basically the same for centuries. . . . This suggests . . . the need for a broader test of incapacity to protect understood but uncontrolled actions by mentally ill persons.

In the field of contract law, the right to disaffirm by a mentally incapacitated party is well established upon an adequate showing of proof that the incompetent lacked cognitive ability to comprehend the nature of the transaction. See generally 2 SAMUEL WILListon, A TREATISE ON THE LAW OF CONTRACTS ch. 10 (Walter H.E. Jaeger ed., 3d ed. 1959); Milton D. Green, Judicial Tests of Mental Incompetency, 6 Mo. L. REV. 141 (1941). Only a few reported civil (in contrast to criminal) cases, however, have expanded the standard beyond cognitive competence to require freedom from a psychological defect, such as manic-depression, that robs the actor of volitional capacity—the ability to control his or her actions. As to the right to disaffirm on grounds of lack of volitional control due to a manic-depressive condition, compare Smalley v. Baker, 69 Cal. Rptr. 521 (1968) (disregarding the volitional defect) with Faber v. Sweet Style Mfg. Corp., 242 N.Y.S.2d 763 (N.Y. Sup. Ct. 1963) (lack of volitional control as incapacitating) and Nohra v. Evans, 509 S.W.2d 648 (Tex. Ct. App. 1974).

The paucity of reported cases may not be a fair gauge of what is in store for the future. To date individuals identified as suffering from a compulsive disorder tend to be those whose contracts are unenforceable on grounds of illegality or subject matter (e.g., gambling), or whose drug or alcohol addictions make them obviously incapacitated to contract under the cognitive standard. With the recent explosion in recognized categories of compulsive-addictives, a new category of litigants may be emerging who may soon seek to test the outer bounds of relief, whether in contract or tort, from economic losses suffered as a result of their conditions.

Zarin is itself a prime illustration: a tax deficiency of $5,209,033.96 erased from the rolls on the theory that the overextended (compulsive) gambler’s debts were unenforceable under local law. Zarin v. Commissioner, 916 F.2d 110, 112 (3d Cir. 1990).

The court in Ortelere concedes that “[o]f course, nothing less serious than medically classified psychosis should suffice or else few contracts would be invulnerable to some kind of psychological attack.” Id. at 466. The dissenting opinion points out that:

The generally accepted test of mental competency to contract . . . is whether the party attempting to avoid the contract was capable of understanding and appreciating the nature and consequences of the particular act or transaction which he challenges . . . . This rule represents a balance struck between policies to protect the security of transactions between individuals and freedom of contract on the one hand, and protection of those mentally handicapped on the other hand.
Another reason for federal tax results not to vary as a function of local attitudes toward compulsive conditions is the strong interest of the tax system in geographic neutrality. Lack of uniformity throughout the states in doctrine about the relevance of compulsion or other mental handicaps is already clearly apparent. Differing attitudes are manifest about the capacity to contract and to execute wills or gifts. So too, a cause of action for creditor practices that sounds in tort under the laws of one state, and that yields compensatory damages for a personal injury akin to emotional harassment (e.g., for the creditor's wrongful exacerbation of a debtor's vulnerable mental or compulsive condition), could elsewhere be groundless as a tort for personal injury, but the source of (taxable) punitive damages instead. These variations could exacerbate taxpayers' frustrations over apparent inequities in the tax system and the success of its self-assessment goal. It could also cause taxpayers to seek local legislative developments that have little to recommend them aside from the promise of producing tax savings.

To forestall geographic variations or tax-based upheavals in local law, administrators and arbiters of the federal tax law ought in the absence of congressional directive either to ignore all taxpayers' compulsive conditions, or treat all taxpayers with like afflictions on a par. In either case the outcome would be without regard to differences in local law. If the former course were followed (as this author believes should be the case), local law awards of damages or

Id. at 468 (Jasen, J., dissenting) (citations omitted).


The Supreme Court on several occasions has taken note of the federal interest in interpreting the Code to give "a uniform application to a national scheme of taxation." E.g., Burnet v. Harmel, 287 U.S. 103, 110 (1932). See authorities cited supra note 148; see generally Milton D. Green, Proof of Mental Incompetency and the Unexpressed Major Premise, 53 YALE L.J. 271, 274 (1944) (indicating that the competency standard for determining capacity to contract varies widely from state to state, and even within the same state, 'courts are in hopeless conflict').

See supra note 154.


Differences among the legal rules of various states, and concomitant variations in tax results, produced mischievous results in the past that took congressional action to correct. The most prominent illustration was the threat in the 1930's and 1940's of sweeping adoption of community property laws to replace traditional common law property systems under which domiciliaries were less favorably taxed than their counterparts in community property states. The movement was arrested with the enactment by Congress of the marital deduction and gift-splitting provisions in the estate and gift tax law, along with the privilege of joint filings of income tax returns by spouses. The historical background is described briefly in Druker v. Commissioner, 697 F.2d 46 (2d Cir. 1982), cert. denied, 461 U.S. 957 (1983). See generally Boris I. Bittker, Federal Income Taxation and the Family, 27 STAN. L. REV. 1389 (1975).
relief from contract based on compulsive conditions would be treated as taxable windfalls, without special valuations or other dispensations to reduce the tax base of a compulsive actor. Relief from penalties might still be granted, however, to an actor who meets the tax law's statutory standards on insolvency or bankruptcy, or whose condition has developed into a physical ailment for which the recompense qualifies for relief as a traditional personal injury award.

The alternative of achieving geographic uniformity by reducing the tax base of compulsive actors to reflect their compulsive conditions, and again without reference to state law, could prove to be an administrative nightmare that compounds inequities among taxpayers and inefficiencies at both the micro and macroeconomic levels. Revenue drains aside, this approach could open the floodgates to line-drawing and other administrative problems that are better left to Congress to resolve. Identification of the actors deserving of tax relief cannot be determined simply by reliance on a taxpayer's having been the subject of an expert clinical diagnosis of an obsessive-compulsive personality. The diagnosis should be a necessary but not sufficient condition for concluding that the tax standard for relief had been met. Moreover, once the standard is established, experts would more than likely disagree over the diagnosis, over whether it was a cause of the behavior in the current case, or whether it was a condition relevant to the standard at issue.

158 Compare the relief for such status authorized by section 108(a)(1)(A) or (B).

159 I.R.C. § 104(a)(2).

160 See Loren H. Roth et al., Tests of Competency to Consent to Treatment, 134 AM. J. PSYCHIATRY 279 (1977) ("Law and, at times, psychiatry are concerned with an individual's competency to stand trial, to make a will, and to contract. The test of competency varies from one context to another. . . . A person may be considered competent for some legal purposes and incompetent for others at the same time."). Accord Brucken et al., supra note 67; cf. Robert M. Veatch, Generalization of Expertise, reprinted in 1 THE HASTINGS CENTER STUDIES, No. 2, at 29 (1973) (medical diagnosis not also a legal judgment).

161 The pertinent legal standard should address whether the compulsive did or did not enjoy an accession to wealth as a result of his or her condition, or whether the affliction warranted relief from tax penalties or the remedy of deferred tax payments.

162 When diagnosis of psychiatric conditions, such as compulsion, becomes relevant to the issue of capacity in a legal adjudication, a war among experts commonly ensues. See, e.g., United States v. Gillis, 645 F.2d 1269 (8th Cir. 1981) (illustrating a common division between experts for the prosecution and for the defense on the question of whether defendant's compulsive gambling was a sufficient mental disease or defect to deny the requisite substantial capacity required for the commission of a crime). A like difference between the parties' experts typically occurs in civil litigation on mental competency and capacity to contract. See, e.g., Faber v. Sweet Style Mfg. Corp., 242 N.Y.S.2d 763, 768 (N.Y. Sup. Ct. 1963) ("[I]n the great majority of cases psychiatrists of equal qualification and experience will reach diametrically opposed conclusions on the same behavioral evidence.").

163 See, e.g., Fingerhut v. Kralyn Enter., Inc., 337 N.Y.S.2d 394 (N.Y. Sup. Ct. 1971) (plaintiff was clearly diagnosed and even hospitalized for a manic-depressive condition that the court nonetheless found was not the cause of his entering into the contract at issue before the court).

164 Cf. United States v. Torniero, 735 F.2d 725 (2nd Cir. 1984) (affirming conviction despite insanity defense based on compulsive gambling; Second Circuit held that trial court was within its discretion in ruling that the relationship between compulsion to gamble and urge to steal is too tenuous to warrant introduction of expert witnesses). See also United States v. Shorter, 809 F.2d 54 (D.C. Cir. 1987) (affirming conviction despite defense that compulsive condition negated element of willfulness necessary to conviction for tax evasion; no consensus among experts of link between pathological gambling and failure to pay taxes, cert. denied, 484 U.S. 817 (1987).

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Nor could these problems be mitigated by reference to standards that have been adopted in other areas of the law as to an individual's mental competency. The purposes of the tax law are distinct from those of other bodies of the law.

This may render the standards from other areas of the law inappropriate for tax law purposes, whether the standards of competency are those developed for determining mens rea for purposes of the criminal law, or the competence of an individual either to contract or execute a gift or will, or to provide informed consent to a medical regime, or to avoid appointment of a conservator or involuntary commitment.

The obvious difficulties courts face in other fields in attempting to work out proper dogma on the legal role of compulsion-addiction and its relevance to economic losses are compounded within the tax field. The overarching mandate of the tax law is to raise revenues, and to do so in an equitable, efficient, and administrable manner. As suggested earlier, any line-drawing in this area could disadvantage some who are, for all practical purposes, indistinguishable from the favored class. True, federal tax law is rife with line-drawing distinctions that are arbitrary at best. Professor Shaviro and a rich body of literature cited by him demonstrate this to be inescapable. But that does not mean that the task is fit for the judiciary and should be taken over from Congress.

An excellent brief summary of the purposes and goals of the income tax system appears in Dodge, supra note 4, at 688-91. The survey encompasses, besides revenue raising, allocation and redistribution in the interests of society at large. Cf. W. Page Keeton, et al., Prosser and Keeton on the Law of Torts §1, at 5-6 (5th ed. 1984):

Contract liability is imposed by the law for the protection of a single, limited interest, that of having the promises of others performed. Quasi-contractual liability is created for the prevention of unjust enrichment of one person at the expense of another, and the restitution of benefits which in good conscience belong to the plaintiff. The criminal law is concerned with the protection of interests common to the public at large, as they are represented by the entity which we call the state. There remains a body of law which is directed toward the compensation of individuals, rather than the public, for losses which they have suffered where the law considers that compensation is required. This is the law of torts. [It], then, is concerned with the allocation of losses arising out of human activities.

The purpose...is to...afford compensation for injuries sustained by one person as the result of the conduct of another.

Id. (footnotes omitted). As to the policy interests served by the requirement of mental competency in the field of contracts, see generally Milton D. Green, Public Policies Underlying the Law of Mental Incompetency, 38 Mich. L. Rev. 1189 (1940).

Cf. State ex rel. Fulton v. Scheetz, 166 N.W. 2d 874 (Iowa 1969) (clinical diagnosis of "mental disease or defect" does not necessarily have the same meaning as does the identical test that is used for criminal purposes). See generally Annotation, Pathological Gambling as Basis for Defense of Insanity in Federal Criminal Case, 76 A.L.R. Fed. 749 (1986).


Wherever the line is drawn, an implicit toll is taken from the uncovered. Revenues that are foregone from those who suffer from compulsive conditions effectively are diverted from those in recovery who look to federally subsidized drugs or rehabilitation clinics for hope and treatment.\(^1\)

It is not only the afflicted who comprise the affected population. Every potential beneficiary of a federally funded program, from pre-schoolers to the aged, afflicted or not, is indirectly affected. So are a larger universe of members from all walks of society who, as taxpayers, share an economic concern over the allocations of entitlements and rights to protections.

Nor is it just a monetary issue that is at stake. Moral judgments are implicated, and without broadscale consensus on the right answers. Some small measure of disparate attitudes in society toward different psychological impediments can be found in recent federal legislation designed to protect the mentally disabled from discrimination in the workplace; excluded from the shelter of this protection are a select group of compulsive persons, including kleptomaniacs along with compulsive gamblers.\(^2\) Should arbiters of tax litigation preempt the public's views on these issues?

IV. CONCLUSION

The recorded consensus by judges and commentators in favor of tax relief for Zarin obviously demonstrates a sympathetically humane reaction to a distinctly appealing plight. Driven to gamble compulsively by a psychological aberration, Zarin suffered dearly from loss of personal fortune. The toll from his compulsive gambling would have been grossly aggravated had the tax levy growing out of that very aberration been sustained.

Although distinctly appealing, Zarin's misfortunes are not unique. Losses of wealth, family, even health and personal freedom,\(^3\) are commonplace among sufferers of compulsive and addictive conditions. Inspired by the outcome of Zarin's litigation, others may likewise seek a haven (at least from tax) in their struggles for income needed, earned, and applied solely to satisfy compulsive urges. If judges and academicians were moved favorably in response to Zarin, surely jurors would look sympathetically on contests between the mentally afflicted and the tax collector. The implications of the Zarin decision would add powerful support for relief in the interests of horizontal and vertical equity.\(^4\)

\(^1\)See, e.g., H.R. 3399, 102d Cong., 1st Sess. (1991) (proposing establishment from federal funds of a program to provide rehabilitation services to people suffering drug or alcohol addiction).

\(^2\)The Americans with Disabilities Act of 1990, 42 U.S.C.A. § 12,101 (West 1991), has as its purpose to provide a "clear and comprehensive national mandate for the elimination of discrimination against individuals with disabilities." 42 U.S.C.A. § 12,101(b). The term "disability" is defined to mean "a physical or mental impairment that substantially limits one or more of the major life activities of such individual." Id. § 12,102(2)(A). Excepted from this definition are "compulsive gambling, kleptomania, or pyromania; or psychoactive substance use disorders resulting from current illegal use of drugs." Id. § 12,211(b)(2).

\(^3\)For compulsive gamblers, a typical cycle of fortune includes losses, embezzlements, and incarceration. See, e.g., Carmel v. Commissioner, 134 B.R. 890 (N.D. Ill. 1991).

\(^4\)Compare Glazer v. Commissioner, 40 T.C.M. (CCH) 1065, 1067, T.C.M. ¶ 91,570 (1980) (sustaining penalty against nonrecordkeeping, compulsive gambler, with the observation: "Our..."

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This article argues not for denial of relief, only for a legislated resolution. Today, determinations of reportable income and a vulnerability to tax penalties from compulsive and addictive conditions turn on the vagaries of local law, 175 unguided sympathies in the judicial system, 176 and current statutory exceptions to COD income for insolvent and bankrupts, 177 which offer tax relief only for the afflicted who encounter financial ruin after borrowing (not working or stealing) for their pathological habits. Change in doctrine requires congressional action. So does the task of balancing other demands upon the tax system in the course of formulating standards on qualifications for tax relief by the allegedly afflicted, as well as the appropriate terms and scope of that relief. 178

Here then is another negative vote on Zarin. It is cast partly in the event, as Professor Newman suggests, that someone else might be keeping tally. 179 The intention is also to register an appeal—that any subsequent nose count on Zarin carefully heed the camel’s nose.

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sympathy for the severity of the petitioner’s past gambling mania simply would not justify our holding that he was not negligent or that he did not intentionally disregard respondent’s rules and regulations.”) with Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990) (granting unprecedented exclusion from income to a compulsive gambler) (discussed supra in text accompanying notes 29-47).

175 See supra text accompanying notes 64-69.
176 See, e.g., authorities cited supra note 174.
177 See I.R.C. § 108(a)(1)(A), (B).
178 A confluence of expert input should be sought. In addition to the usual legal and economic experts, the collaborators should include medical scientists knowledgeable about the role of compulsion or addiction in an actor’s conduct, moral philosophers with informed views about assigning societal and personal responsibility for actions, and legislators sensitive and accountable to public opinion about allocation and distribution of risks and protections. What seems clear is that the exercise of defining the protected class as well as the appropriate form and scope of relief exceeds the parameters of the tax judiciary’s realm.

179 Newman, supra note 4, at 667 ("[I]n case anyone is keeping score, I think Zarin realized taxable income.").

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