92 T.C. 1084 (1989)

Income from the discharge of indebtedness can occur even when the underlying debt is arguably unenforceable, particularly when the debtor received something of value in exchange for the debt.

Summary

David Zarin, a compulsive gambler, incurred a substantial gambling debt to Resorts Casino in Atlantic City. Resorts extended credit to Zarin, who used markers to obtain chips. When Zarin was unable to repay $3.4 million in debt, Resorts sued him. They eventually settled for $500,000. The IRS argued that the $2.9 million difference was income from discharge of indebtedness. The Tax Court agreed, holding that Zarin received value in the form of gambling chips and the opportunity to gamble, and the subsequent debt discharge constituted taxable income, regardless of the debt's enforceability under state law.

Facts

David Zarin was a professional engineer and a compulsive gambler. Resorts Casino in Atlantic City extended Zarin a line of credit for gambling. Zarin used markers (counter checks) to obtain chips, accumulating a debt of $3.4 million by April 1980. Resorts continued to extend credit despite knowing about Zarin's gambling habits and potential credit risks. Resorts filed a lawsuit to recover the debt when Zarin failed to pay. Zarin and Resorts settled the lawsuit in 1981 for $500,000, which Zarin paid.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Zarin's federal income taxes for 1980 and 1981. Initially, the IRS asserted income from larceny by trick and deception for 1980. This position was later abandoned. In an amended answer, the IRS asserted additional taxable income for 1981 based on the discharge of indebtedness. The Tax Court addressed only the discharge of indebtedness issue for 1981.

Issue(s)

1. Whether the difference between the face amount of gambling debts ($3.4 million) and the settlement amount ($500,000) constitutes taxable income from the discharge of indebtedness under Section 61(a)(12) of the Internal Revenue Code.

Holding

1. Yes, the difference constitutes taxable income from the discharge of indebtedness because Zarin received value in the form of gambling chips and the opportunity to gamble, and the subsequent reduction of his debt resulted in a freeing of assets,

fitting the definition of income from discharge of indebtedness.

Court's Reasoning

The court reasoned that gross income includes income from the discharge of indebtedness under Section 61(a)(12). Citing *United States v. Kirby Lumber Co.*, the court stated the gain from debt discharge is the "resultant freeing up of his assets that he would otherwise have been required to use to pay the debt." The court rejected Zarin's arguments that the debt was unenforceable under New Jersey law and that the settlement was a purchase price adjustment. The court distinguished *United States v. Hall*, noting that the modern view, supported by *Commissioner v. Tufts* and *Vukasovich, Inc. v. Commissioner*, emphasizes the economic benefit received by the debtor when the debt was initially incurred. The court stated, "We conclude here that the taxpayer did receive value at the time he incurred the debt and that only his promise to repay the value received prevented taxation of the value received at the time of the credit transaction. When, in the subsequent year, a portion of the obligation to repay was forgiven, the general rule that income results from forgiveness of indebtedness, section 61(a)(12), should apply." The court also dismissed the purchase price adjustment argument, finding that gambling chips and the opportunity to gamble are not the type of "property" contemplated by Section 108(e)(5).

Practical Implications

Zarin v. Commissioner clarifies that even if a debt is legally questionable, its discharge can still result in taxable income if the debtor initially received something of value. This case highlights that the focus is on economic benefit rather than strict legal enforceability when determining income from discharge of indebtedness. For legal practitioners, this case underscores the importance of considering the economic realities of transactions and not solely relying on the legal enforceability of debt instruments in tax planning. It also demonstrates that gambling debts, despite their unique nature, are not exempt from general tax principles regarding debt discharge. Subsequent cases may distinguish *Zarin* based on the specific nature of the "value" received and the enforceability of the debt, but the core principle remains: economic benefit from debt, even gambling debt, can lead to taxable income upon discharge.

