JOINT AND SEVERAL LIABILITY: A COMMON ARRANGEMENT WITH UNCOMMON TAX CONSEQUENCES

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Table of Contents

I. Introduction .................................. 1021
II. Legal Rights and Obligations of Co-Obligors ................. 1021
   A. ‘Primary’ Versus ‘Secondary’ Obligors .................................. 1022
   B. Rights of Contribution and Subrogation ................................. 1023
III. Tax Treatment of Co-Obligors .......................... 1025
   A. Interest Deductions ........................................ 1025
   B. Section 108 ........................................ 1033
   C. Liability Shifts Among Co-Obligors .................................. 1034
   D. Source of Payments ........................................ 1037
IV. Conclusion ..................................... 1038

I. Introduction

Joint and several liability is a very common arrangement. The tax consequences that can flow from that arrangement, however, can be quite unexpected, and, some would say, anomalous.

This report analyzes various tax issues that arise when parties agree to be jointly and severally liable for a debt obligation (that is, when more than one party is treated as being “primarily liable” for the same performance under a single indebtedness).1 As discussed in greater detail below, a party that is determined under judicial or administrative law to be primarily liable on a debt instrument may be treated dramatically differently for federal tax purposes than a party that is a guarantor. For example, under section 163(a),2 a primary obligor may be entitled to a current deduction when interest is paid or accrued on the debt, whereas a payment of interest by a guarantor is deductible only as a bad debt loss (which may be a short-term capital loss as opposed to ordinary) under section 166, and then only when any claim for reimbursement or subrogation for payment becomes worthless.

Part II of this report discusses the rights and obligations of joint and several liability under commercial law. Part III reviews how specific aspects of joint and several liability have been treated under tax law, including interest deductions, cancellation of debt income, liability shifts (such as full assumptions or additions of co-obligors), and miscellaneous international tax issues that arise in the joint and several liability context. Finally, Part IV discusses briefly whether the tax law distinctions between primary and secondary liability make sense from a policy perspective.

II. Legal Rights and Obligations of Co-Obligors

Section 163(a) provides that “[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.” Courts and the IRS have interpreted section 163 as allowing a taxpayer to deduct interest only on an obligation for which it was “primarily

1For simplicity, the report assumes that each liability discussed in the report has been created as a result of a borrowing of cash for use in the acquisition of an asset or funding of other expenses of the borrower(s), unless otherwise indicated.

2Unless otherwise specified, section references are to the Internal Revenue Code of 1986, as amended.
reimbursable."

Because federal tax law generally looks to common
law to determine the rights and obligations of the
parties, an analysis of what the term "primary liability"
means under common law is worth reviewing. Unfor-
fortunately, as discussed in detail below, primary liability
may have different meanings in different contexts.

One of the first steps in analyzing primary liability
under common law — and distinguishing it from
secondary liability — is to determine which common
law or laws govern the arrangement. Does federal or
state law (or both) apply? If state law, then the law of
which state? Assuming the law of only one state governs,
is the arrangement governed by state statutory law? If
not, then what type of common law applies (contract law,
equitable law, or other)? In many cases, the parties may
contractually agree on which state law applies. That law
will generally govern the arrangement unless supplanted
by federal law (for example, bankruptcy law).

Each state has enacted a version of the Uniform
Commercial Code (UCC), which contains several articles
potentially applicable to such arrangements. Also, states
have enacted both general statutes (such as law generally
applicable to contracts or sureties) and specialized stat-
utes (such as law applicable to creditors, commercial
financing, insurance, partnership, mortgages, personal or
intangible property, and others areas) that may govern
multiparty loan arrangements.

If state statutory law is inapplicable or absent, then
state common law will govern the arrangement. Com-
mon law applicable to multiparty loan arrangements is
generally reflected in several Restatements of the law.5
When the arrangement is governed by the state statute,
however, statutory law will take priority over common
law. In such a case, state common law can supplement
the statute, but it cannot supplant the statute.

Finally, subject to UCC/common law rules of good
faith6 and unconscionability (under state law) as well as
other antiabuse provisions (under both federal and state
law), parties to a transaction have freedom to contract
and to vary their arrangement in the manner and to the
extent they agree.7 For example, the right of contribution,
reimbursement, or subrogation (discussed below), which
otherwise arises under equity when a co-obligor pays
more than its proportionate share of a liability, may
generally be modified, or waived partially or entirely.8

A. ’Primary’ Versus ‘Secondary’ Obligors

Although it may be obvious from the face of an
agreement which of several parties is a primary obligor,
in many cases, a deeper analysis may be required.9 In
making that analysis, several items should be noted.

First, when the statement is made that a party does not
have “principal” or “primary” liability but only sec-
ondary liability, it does not necessarily mean that the credi-
tor’s assertion of its right against that party must be
postponed until some condition is satisfied or some
action is taken against the principal or primary obligor.10
As far as the creditor is concerned, the secondarily liable
person may be the primary obligor in the sense that there
is no condition or contingency that must be satisfied
before the creditor can proceed against that person.11
Generally, when principal and surety are bound jointly,
from the standpoint of the creditor there is no secondary
liability.12 Thus, the terms primary and secondary
generally refer to the rights of two debtors vis-à-vis each other.

Second, the terms “primary” and “secondary” may
have different meanings in different contexts and may be
modified by contract. As one court, citing 2 F. Hart and W.
Willier, Bender’s Uniform Commercial Code Service,
section 13.03 at 13-10 (1976), stated: Equally confused and misleading has been the use of
the terms “secondary” and “primary” with refer-
ence to contractual liability and to the suretyship
transaction. In the suretyship sense, “secondary”
simply refers to the fact that the obligor rather than
the surety ought to pay or perform; hence, his
obligation is “primary” and the surety’s “sec-
ondary.” However, in a contractual sense, “secondary”

3See, e.g., Guardian Investment Corp v. Phinney, 253 F.2d 326
(5th Cir. 1958); United States v. Norton, 250 F.2d 902 (5th Cir.
1958); Commissioner v. Henderson’s Estate, 147 F.2d 619 (5th Cir.
1945); Nelson v. Commissioner, 281 F.2d 1 (6th Cir. 1960); Stratmore
v. Commissioner, 785 F.2d 419 (3d Cir. 1986); Treas. reg. section
1.163-7(a) (deduction for original issue discount permitted
only to the extent the issuer is primarily liable on the debt
instrument”). However, there is a limited exception to this rule
permitting a deduction for interest on a realty mortgage even
when the taxpayer is not directly liable on the bond or note
secured by the property. See Treas. reg. section 1.163-1(b).

4See, e.g., article 1 (General Provisions); article 3 ( Negotiable
Instruments); article 8 (Investment Securities); and article 9
(Secured Transactions).

5See, e.g., Restatement (Third) of Suretyship & Guaranty (1996),
Restatement (First) of Security (1941), Restatement (Second) of
Contracts (1981), Restatement (Third) of Property (Mortgages)
(1997), and Restatement of Restitution & Unjust Enrichment (Ten-
tative Drafts 2000).

6See, e.g., UCC section 1-304.

7See, e.g., UCC section 1-302.

8See, e.g., Hardy v. McMullan, 612 So.2d 1146 (Ala. 1992).

9Restatement (Third) of Suretyship & Guaranty, section 1, cmt. p
(1996).

10Restatement (First) of Security, section 82, cmt. f (1941).

11Id. For instance, in the context of a letter of credit, courts
have at times confused the primary liability of the issuer of the
letter with the primary liability of the obligor on the debt
supported by the credit. See Hamada v. Far East Nat’l Bank, 291
F.3d 645, 656 (2002) (“The Kaiser court correctly observed that an
issuer’s obligation to honor a standby letter of credit is consid-
ered a primary obligation . . . However, the Kaiser court failed
to distinguish between the ‘primary’ liability of a debtor to its
creditor to repay a loan and the primary obligation of the issuer
to its beneficiary to honor a letter of credit. When a standby
credit supporting a loan is honored, the issuer admittedly is
satisfying its obligation as a primary obligor to honor the
credit. But when the issuer is supporting a loan, the issuer is
secondarily liable for which a person other than the issuer is primary liable. This

12Id.
refers to conditional liability, that is, conditions precedent to the promisor’s duty of performance, while “primary” refers to an unconditional or absolute duty to perform. Thus, a surety is always “secondarily” liable in the suretyship sense, but he may be either “primarily” or “secondarily” liable in the contractual sense, depending upon the terms of his agreement with the obligee.13

Third, the term “ultimate liability” has been used in some contexts to determine primary liability. For instance, the Restatement (First) of Security states that “the one who has the principal or primary obligation, in suretyship, is the one who, considering the situation as a whole, has the ultimate liability, or who would have the ultimate liability were it not for some defense, such as infancy, which is personal to himself.”14 That suggests that ultimate liability should be attributed to the one whose performance of the obligation does not give rise to a right of contribution or subrogation against another.

As stated above, when analyzing the relative rights and obligations of co-obligors, there are various bodies of law that can apply. While an examination of those bodies of law goes beyond the scope of this report, it is helpful at least to summarize the salient points of common law (noting that some of the rights and obligations might vary from jurisdiction to jurisdiction, or if other statutory regimes apply).

The Restatement (Third) of Suretyship & Guaranty (1996) uses the phrase “principal obligor” instead of “primary obligor” to refer to that one obligor as between various co-obligors that has the duty to the other to perform the underlying obligation. The key is the relationship between the two obligors. Generally, as discussed above, a party that is primarily liable on an obligation cannot invoke the right of subrogation. In distinguishing between the principal obligor and the secondary obligor, the Restatement says:

When an obligee has rights against two obligors but is entitled to only one total recovery, the obligee can usually recover from either obligor and those obligors can subsequently reallocate the cost of performance between themselves in accordance with the rights and duties between them created by their agreement. The one obligor who has the duty ultimately to bear the cost of performance is the principal obligor, and the other obligor is the secondary obligor. The allocation of that duty may be determined by agreement or by the relationship between the obligors. In most cases, it will be obvious from the face of the agreements which obligor is the principal obligor and which one is the secondary obligor. In some cases, though, some investigation into the underlying facts may be required. This is most likely to be the case when the two obligors have cosigned a promise to pay money. Determining which obligor has the duty to bear the cost of performance, or whether the two

each have a duty to bear part of the cost, may depend on which obligor received the direct benefit of the consideration for the promise, or whether they shared that benefit.15

While the case law is not always entirely consistent, the general rule is that the co-obligor that receives a direct benefit as a result of the liability incurred is considered the primary or principal obligor regarding that liability. If both parties receive direct benefits, each co-obligor would typically be considered primarily liable to the extent of the benefit received and “secondarily” liable regarding that portion for which liability exists but no benefit was received.

B. Rights of Contribution and Subrogation

Contribution and subrogation, although they are both based on the same broad general principles of equity, are separate and distinct rights. A party entitled to subrogation is entitled to recover from the party primarily liable for performing on the underlying obligation, whereas a party entitled to contribution is entitled to recover from another party with whom he shares liability.17 Subrogation gives the party paying the underlying obligation all the rights and remedies of the creditor; thus, subrogation is a broader right that may include the right to contribution. Contribution is not derived from, or dependent on, subrogation,18 despite the fact that in a given case both rights may be sustained,19 and that subrogation may be available to enforce a right to contribution (as discussed below).20

1. Contribution. The right of contribution rests on principles of equity and not on contract. It is an attempt by equity to distribute equitably among those who have a common obligation, the burden of performing that obligation. As expressed in Restatement (First) of Restitution, section 82 (1937), the rule is that unless otherwise agreed, a person who has discharged more than his proportionate share of a duty owed by himself and another is entitled to contribution from the other. Generally, the right of contribution arises when the payer has paid more than his share if the debt is due at the time of payment; if paid before that due date, the right will arise on the due date.21 A co-obligor is entitled to contribution for interest

14Restatement (First) of Security, section 82, cmt. f (1941).
15Restatement (Third) of Suretyship and Guaranty, section 1, cmt. p (1996).
16Am. Jur.2d Contribution, section 3 (citing Chamison v. HealthTrust, Inc. — Hospital Co., 735 A.2d 912 (Del. Ch. 1999), aff’d, 748 A.2d 407 (Del. 2000); U.S. Fidelity & Guaranty Co. v. Brannwell, 108 Or. 261, 217 P. 332 (1923)).
18Free v. Scollar, 101 Neb. 131, 162 N.W. 496 (1917); Central Banking & Security Co. v. U.S. Fidelity & Guaranty Co., 73 W. Va. 197, 80 S.E. 121 (1913); Smith v. Hudson, 50 Wis. 279, 6 N.W. 812 (1880).
19Taylor v. Taylor, 47 Ky. 419, 8 B. Mon. 419, 1848 WL 3302 (1848).
20See below.
21Restatement (First) of Restitution, section 82 (1937). Regarding co-obligors of debt, it is unclear whether an incremental right of contribution arises each time, and at such times, that one (Footnote continued on next page.)
at the “legal” rate on payments made in excess of its share.\textsuperscript{22}

Without an agreement, the share of a debt owed by secondary liable co-obligors is considered to be shared equally.\textsuperscript{23} As long as all such co-obligors remain solvent, co-obligator timely pays more than his or her share of the periodic interest due on such debt, or whether only one right of contribution arises when the co-obligor pays more than his or her share of the total interest and principal at maturity or otherwise. Common law supports the theory that when one of multiple co-obligors makes partial payments on a debt, a right of contribution arises as to such payments from the time the co-obligor pays the creditor more than its share of all payments (aggregating both interest and principal) due under the debt, and thereafter, separate rights of contribution arise on those payments made thereafter. See Kee v. Lofton, 12 Kan. App. 2d 155, 737 P.2d 55, 59 (Kan. App. Ct. 1987); Robinson v. Jennings, 70 Ky. 630 (1870); and Bushnell v. Bushnell, 77 Wis. 435, 46 N.W. 442 (Wis. 1890).

However, one could argue that interest payments in excess of the periodic interest due give rise to incremental rights of contribution, regardless of whether those payments exceed the aggregate sum of principal and interest. For instance, under common law, if one party’s reasonable and necessary expenditures to protect or maintain an interest in property relieves a second party’s obligation to do the same by virtue of the second person’s interest in the same property, the first party has a right of restitution against the second as necessary to prevent unjust enrichment. See Restatement (Third) of Restitution & Unjust Enrichment, section 24 (T.D. Nov. 2, 2002). Applying that rule to co-owed debt, if one obligor makes necessary interest payments in excess of his proportionate share of the interest due, to prevent a default on the underlying debt, that party should arguably be entitled to an incremental right of contribution for the excess, despite the fact that (i) such obligor has not paid more than his share of the entire principal and interest; and (ii) the interest payment is made before the maturity of the underlying debt instrument. See Koppers Co. v. Commissioner, 11 T.C. 894 (1948) (discussed below, in which the IRS argues that an obligor’s interest in the same property, the first party has a right of restitution). It is argued that it is equitable to attribute the interest paid in excess of the parties’ obligation to prevent a default on the underlying debt, and that the obligor should be entitled to an equitable right to contribution for the excess interest paid.

As long as all such co-obligors remain solvent, generally, any secondary liable co-obligor who pays the entire amount is entitled to recover from each of the other co-obligors a sum equal to that amount divided by the number of persons participating.\textsuperscript{24} If one of the obligors is insolvent, another co-obligor who makes a payment is entitled by a proceeding in equity to have contribution from the others as if the insolvent had originally not participated.\textsuperscript{25}

Although joint and several obligors are presumed to share the debt equally, that presumption can be overcome by a showing that each obligor received unequal benefits from the debt.\textsuperscript{26} Additionally, co-obligors are free to regulate their rights and liability as among themselves by contract.\textsuperscript{27} Accordingly, co-obligors may agree to bear unequal shares of the debt.\textsuperscript{28}

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\textsuperscript{22} Buckmaster v. Grundy, 8 Ill. 626 (1846); Titcomb v. McAllister, 81 Me. 399, 17 Atl. 315 (1889), Smith v. Mason, 44 Neb. 610, 63 N.W. 41 (1895); Campbell v. Mesier, 6 Johnns. ch. 21 (N.Y. 1822); Hitchman v. Stewart, 3 Drew. 271 (1855); Bushnell v. Bushnell, 77 Wis. 435, 46 N.W. 442 (1890); Lawson v. Wright, 1 Cox’s Eq. 275 (1786); Ex parte Bishop, 15 ch., Div. 400 (1880). Although it may be unclear what the “legal” rate means in each case, it generally is not the rate of the underlying obligation unless the jurisdiction allows the co-obligor to be subrogated to the rights of the creditor. See generally C.C. S. Patrinelis, “Rights of One Entitled to Contribution to Recover Interest,” 27 A.L.R. 2d 1268 (1996).

\textsuperscript{23} Restatement (First) of Restitution, section 85 (1937). The rule is slightly different when a partnership is involved. Thus, if co-guarantors of a note owed by a partnership are members of that partnership, each guarantor’s share of the note is based on its percentage of ownership interest in the partnership. Jans v. Nelson, 83 Cal. App.4th 848, 100 Cal. Rptr. 2d 106, 111 (2000). Compare that case to Curtis v. Cichon, 462 So.2d 104 (1985). (Stockholders were guaranteed the debt of a corporation, in which each held unequal amounts of the corporation’s outstanding shares. The court held their joint and several liability presumed equal liability, and that presumption had not been overcome by a showing of intent to apportion their liability according to their percentage of stock ownership.)

\textsuperscript{24} Restatement (First) of Restitution, section 85, cmt. e (1937). If in partial satisfaction one co-obligor pays less than the entire amount but more than his share, he is entitled to recover from each co-obligor who has not paid his share such excess up to the amount of the unpaid share of the other; alternately, he can recover from each of the others the amount of such excess divided by the number of others. For example, if one of five obligors of a $1,000 debt pays the entire $1,000, he is entitled to recover no more than $400 from all of the other co-obligors but no more than $200 from any one co-obligor. If he pays $600 in partial discharge, he is entitled to recover $200 from any one or any two of them, or $100 from each of them. Generally, he cannot, however, recover $120 from each of them, so that each will share equally in the $600 payment, because his right to contribution does not entitle him to bring his loss below that which he should pay if the claim of the creditor were fully discharged. Id.

\textsuperscript{25} Restatement (First) of Restitution, section 85, cmt. h (1937).

\textsuperscript{26} While, in the absence of proof to the contrary, it is presumed that all the co-obligors were benefited in equal degree by the consideration received, this presumption is subject to rebuttal by proof that there was actually an inequality of benefits received. Thus, where several persons borrow money jointly but it is established that, individually, they received unequal parts of that money, they are liable to contribute, not equally, but in proportion to the amounts actually received by them. Curtis v. Cichon, 462 So.2d 104, 106 (1985) (Grimes, J., dissenting on other grounds and citing Restatement (First) of Restitution, section 85, cmt f (1937); Hollingsworth Paving, Inc. v. Paneling Centers of America, Inc., 1987 Tenn. App. LEXIS 2542 (Tenn. Ct. App., 1987).


\textsuperscript{28} Id. Although not entirely clear parties presumably may agree to allocate a debt in a manner other than in proportion to which they received the loan proceeds. An issue may arise regarding whether the co-obligator’s right to contribution is to be based on the original amount of the debt, when the co-obligors have agreed with the creditor to discharge the obligation by payment of some lesser or compromise amount, or whether the plaintiff’s right to contribution is based on the lower settlement amount. For example, assume that A and B jointly owe C $1,000 (both having received $500 from C), and C agrees to accept $300 from A and $200 from B in full satisfaction of the debt. Can A recover contribution from B for $50? If the contribution right is based on the lesser, combined settlement figure of $500, A would be entitled to receive $50 from B, representing their equal share of their obligation, so that each would have paid one-half (Footnote continued on next page.)
2. **Subrogation.** Subrogation generally means that the guarantor or surety (including an accommodation party) steps into the shoes of the creditor on paying the creditor’s claim. In other words, the party entitled to subrogation inherits the rights that the creditor or holder had, no more and no less. Subrogation may be based on contract or equity, or on a statute. One court described the categories as follows:

There are various types of subrogation, most commonly categorized as “conventional” or “contractual” subrogation, “legal” or “equitable” subrogation, and statutory subrogation. “Conventional” or “contractual” subrogation rights arise from an express or implied agreement between the subrogor and subrogee. “Equitable subrogation is a legal fiction, which permits a party who satisfies another’s obligation to recover from the party ‘primarily liable for the extinguished obligation.’” The right of “legal” or “equitable” subrogation arose as a “creature of equity” and “is enforced solely for the purpose of accomplishing the ends of substantial justice.” Statutory subrogation, as one might expect, occurs by virtue of a right created by statute [like section 509 of the Bankruptcy Code].

3. **Blurring the distinction.** Some jurisdictions blur the distinction between a right of subrogation and a right of contribution. For instance, in some jurisdictions, a co-obligor who performs more than her proportionate share of an obligation may be entitled to a right of subrogation (in addition to a right of contribution) provided the entire obligation has been discharged. Although that co-obligor’s amount of recovery will be limited to the amount it would have received had it asserted its right of contribution, that co-obligor may, for example, avail itself of a longer statute of limitations in which to assert its claim (subrogation may have a 10-year statute of limitations, whereas contribution may be limited to a 4-year statute of limitations).

III. **Tax Treatment of Co-Obligors**

**A. Interest Deductions**

As stated above, section 163(a) provides the general rule that “there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.” The courts and the IRS have interpreted section 163 as allowing a taxpayer to deduct interest only on an obligation for which he is “primarily liable.” As a corollary, the courts and the IRS have repeatedly held and ruled that liability for the debt of another, as in the case of a guarantor or surety, is not sufficient to entitle a person to deduct interest on that liability. Some courts have gone one step further and interpreted section 163 as allowing a taxpayer to deduct interest only on an obligation for which he was primarily liable on the debt at the time that the debt was issued. Under that rule, a guarantor would never be primarily liable on the debtor’s indebtedness and thus never entitled to an interest deduction. The Third Circuit, however, has discounted that rule at least in limited circumstances, holding that interest accruing after a guarantor has become liable is deductible by the guarantor if “the original obligor has been discharged from the debt in bankruptcy.”

Although a taxpayer must be “primarily liable” on a debt to be able to deduct payments as interest, the taxpayer need not be the sole obligor. The general rule is that where a taxpayer is jointly and severally liable with another on a debt, the taxpayer’s actual payments of interest are deductible to the same extent as if he were solely liable for the debt. That rule has been sustained, even “where the benefits of the original obligation inured directly to only one of the obligors and the obligor who made payment received only an indirect benefit or had other motives in becoming jointly and severally liable for the debt.”

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31See, e.g., Guardian Investment Corp v. Phinney, 253 F.2d 326 (5th Cir. 1958); United States v. Norton, 250 F.2d 902 (5th Cir. 1958); Commissioner v. Henderson’s Estate, 147 F.2d 619 (5th Cir. 1945); Nelson v. Commissioner, 281 F.2d 1 (5th Cir. 1960); Stratmore v. Commissioner, 785 F.2d 419 (1986); Treas. reg. section 1.163-7(a) (deduction for OID permitted “only to the extent the issuer is primarily liable on the debt instrument”). However, there is a limited exception to this rule permitting a deduction for interest paid on a realty mortgage even when the taxpayer is not directly liable on the bond or note secured by the property. See Treas. reg. section 1.163-1(b).


33Guardian Investment Corp v. Phinney, 253 F.2d 326 (5th Cir. 1958).

34For a good discussion of this issue, see David S. Miller, “Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis,” 48 Tax Lawyer 103 (1994). Note that even though a guarantor may not be entitled to an interest deduction under section 163, it may be entitled to a bad debt deduction under section 166 for amounts paid under the guarantee. The character and timing of the deduction typically make section 163 more desirable than section 166.


36See, e.g., Abdalla v. Commissioner, 647 F.2d 487; Nelson v. Commissioner, 281 F.2d 1 (5th Cir. 1960).

Because the tax treatment of a guarantor differs from that of a “primary” obligor, it is important to distinguish between the two. As will be discussed below, however, the authority relevant to making such a distinction is not always consistent. Another critical issue is the tax treatment of accrual method taxpayers that are jointly and severally liable on a debt. The first aspect of this issue, on which there appears to be no law directly on point, is how to allocate the interest deductions among accrual method co-obligors. The second aspect is how to treat the right of contribution that arises when an accrual method co-obligor pays more than its share of the interest.

1. ‘Primary’ liability under tax law. With some notable exceptions, the general rule is that any co-obligor jointly and severally liable on a debt that makes an interest payment on that debt is eligible for the interest deduction for that payment. While there is ample authority to support that rule, the rationale underlying that authority is often inconsistent and questionable from a general policy perspective.

In Mason v. United States, one of two co-obligors (Cramer) made several payments to the creditor before the petitioner, Mason, made his payment of $25,000. The creditor treated the first payments made during the year as interest and credited Cramer with about $15,000 of interest paid, but only about $350 for Mason. Mason claimed that each of the co-obligors should only be entitled to their ratable share of interest deductions, and because they were 50/50 co-obligors, Mason should have received at least half of the interest deductions.

The court cites the general rule that “a jointly and severally liable obligor is entitled to deduct all the interest paid during a tax year if he is the only payor on the obligation that year.” The court goes on to say that, without an agreement between the creditor and obligor(s), interest is prorated over the term payments are to be made, and each payment is credited first to interest and then to principal. In response to the petitioner’s contention “that application of the rules as proposed by the court will create a significant potential for collusive tax evasion, in that debtors may adjust their incomes and the timing of their payments on a joint obligation so as to maximize the benefit realized from interest deduction,” the court responds:

This possibility causes the Court some concern. However, a taxpayer is entitled to adjust his affairs to reduce his tax liability within the limits of the law. Distortion of income to the extent suggested by plaintiffs would certainly be unlawful, for it would create precisely the type of situation in which the IRS is authorized to alter the taxpayer’s method of accounting to more clearly reflect income.

This decision is quite fascinating. It creates a situation in which co-obligors potentially can engage in a race to make payments on debt to treat the earliest payments as deductible interest, unless there is an agreement with the creditor allocating payments to principal and interest. Interestingly, the court cites to section 446(b) to authorize the IRS to reallocate income, as appropriate, but the cases cited all pertain to the allocation of debt payments between principal and interest, suggesting that the court does not take issue with the fact that any co-obligor making an interest payment gets the interest deduction; rather, the court is concerned with the more common issue of when a payment of a debt is inappropriately characterized as a payment of interest or principal.

The IRS’s published position on this issue is consistent with the case law cited above. For example, in Rev. Rul. 71-179, a father who cosigned a loan to his son was permitted an interest deduction when the father later made interest payments on the loan as the interest payments became due.

Another interesting revenue ruling worth mentioning is Rev. Rul. 72-2, in which tuition and certain other costs for university students are deferred and later repaid by the students after graduation. Each former student’s annual repayment amount is determined as a percentage

38See, e.g., Larson v. Commissioner, 44 B.T.A. 1094, aff’d, 131 F.2d 85 (9th Cir. 1942) (petitioner and son co-signed for loan for son’s use based on petitioner’s credit; petitioner deducted interest she paid in 1934; petitioner made a gift of the loan proceeds to son in 1935; held, petitioner entitled to interest deduction in 1934 with no mention of right of contribution or whether gift amount included the amount of interest paid in 1934, although implication is that gift did not include that amount); Williams v. Commissioner, 3 T.C. 200 (1944) (holding 50 percent shareholder of corporation, who was co-obligor with corporation and other 50 percent shareholder for debt secured by property contributed to and owned by corporation, was entitled to interest deductions for interest payments made by that shareholder; no discussion of rights of contribution and express decision not to discuss issue of worthless debt deduction on theory that they were advances to the corporation); Neracher v. Commissioner, 32 B.T.A. 236 (1935) (husband and wife were co-obligors on note secured by property owned by wife; husband allowed interest deduction for interest paid on the note; no discussion of gift or right of contribution); Arrigoni v. Commissioner, 73 T.C. 792 (1980) (husband and wife who became liable for payroll and sales taxes of corporation they owned could deduct taxes for which they were jointly and severally liable under the statute, and could deduct interest on the tax liabilities because statute made them “primarily” liable when they were made joint and severally liable with the corporation; no statutory right of contribution found by court on other taxes meant no worthless debt deduction for taxes not otherwise deductible).


40Mason, at 849 (citation omitted).

41Baird v. Commissioner, 68 T.C. 115 (1977) (individual deduction of prepaid interest disallowed as distortion of income); Resnick v. Commissioner, 555 F.2d 634 (1977), aff’d 66 T.C. 74 (disallowing deduction of prepaid interest in potentially abusive situation, including one-day tax year generating deduction equal to 92 percent of investment); Sandor v. Commissioner, 62 T.C. 469 (1974), aff’d, 536 F.2d 874 (9th Cir. 1976) (disallowing current deduction for prepaid interest); Estate of Ratliff v. Commissioner, 101 T.C. 276, Doc 93-10299, 93 TNT 203-11 (1993) (IRS permitted to rely on section 446(b) to challenge allocation of debt payments between interest and principal).

421971-1 C.B. 58. See also Rev. Rul. 71-268, 1971 C.B. 58 (mortgage interest payments actually made by husband and wife respecting property owned as tenants in the entirety were deductible by each on their separate tax returns).

431972-1 C.B. 19.
of the former student's income, which obligation to repay shall not exceed 35 years. The former students having such repayment obligations are put into groups. Each person must continue to make payments until such time as the pooled amount owed to the university has been repaid and each person has repaid his or her share of the owed amounts, or until a participant has paid back 150 percent of the amount originally deferred plus interest on that amount. The program provides that payments are first allocated to principal, then to insurance premiums (on the lives of the participants), and then to interest. The IRS concludes that any amounts paid that are allocable to interest are deductible. Thus, those participants with higher incomes are paying a disproportionately large portion of the deferred amounts and will be entitled to deduct the payments treated as interest, while those with lesser incomes may never have to pay more than the deferred costs (without interest). Thus, certain participants are, in effect: (i) paying the interest on the deferred amounts of the other participants; (ii) are entitled to the deductions for those interest payments; and (iii) have no right of contribution, reimbursement, or subrogation.

What is interesting about the above-cited revenue rulings and most of the cases permitting interest deductions to be taken by joint and several co-obligors is that the authorities do not distinguish between situations in which a co-obligor is treated as an accommodation party or a surety under commercial law as compared to when a co-obligor is treated as the principal or primary obligor. For example, the father in Rev. Rul. 71-179 would almost certainly be treated as an accommodation party or surety under commercial law because the son has received all of the loan proceeds. In other words, for purposes of determining interest deductions for co-obligors, the case law and the IRS appear generally indifferent to which co-obligor received the borrowed proceeds — the only inquiry is into whether the co-obligor was directly liable on the debt and whether the co-obligor paid the interest (although, as discussed below, the authority is not entirely without exception). In short, “tracing” of loan proceeds is not relevant to interest deductibility under these rules.

In contrast, in Golder v. Commissioner, the court articulates two separate reasons for denying interest deductions to guarantors. In Golder, the taxpayers, who were the guarantors, would be jointly and severally liable for a debt on any default by the borrower in the payment of principal or interest of the debt, or any other obligation under the debt. The court concludes that the “liability of the guarantors is contingent upon default of the original obligor and as such petitioners are only secondarily liable.” If the distinction between primary and secondary liability is based on that conditionality, there is a fairly bright line that can be drawn regarding which parties are entitled to interest deductions on a debt.

Under such an approach, if a person can be called on to make payments on a debt regardless of whether another obligor has defaulted on the debt, that person is considered primarily liable and is entitled to deduct the interest payment. This “unconditional liability” approach is the analysis adopted in virtually all joint and several liability cases.

However, the Golder court then went on to examine the economic rationale underlying its holding and relies on the reasoning in the Supreme Court case, Putnam v. Commissioner, in which interest deductions were disallowed to guarantors:

The Court reasoned that upon payment a guarantor is immediately subrogated to the rights of the creditor and becomes a creditor himself of the primary obligor. Any resulting loss to the guarantor arises from the worthlessness of the debt now owed to the guarantor and consequently the payments must be treated as bad debt losses rather than losses incurred in a transaction entered into for profit. . . .

As a general matter deductions under Section 163(a) are very different from deductions under section 166. Section 163(a) is concerned with debts (interest) owed by the taxpayer to another, while section 166 is concerned with debts owed to the taxpayer. A problem arises in a guarantor situation, however, because the guarantor is both a debtor and a creditor. Upon default of the primary obligor, the guarantor is called upon for payment. He is contractually bound to pay the sums owed, as any debtor. There is a substantial difference, however, between the debt of the guarantor and that of the primary obligor. Upon payment, the guarantor is immediately subrogated to the rights of the creditor and thereby becomes a creditor himself. For the guarantor, the transaction does not close upon his making payment to the creditor because of this right of reimbursement from the primary obligor. Cf. John E. Montgomery v. Commissioner, 65 T.C. 511, 517-518 (1975). Rather, the transaction closes when the guarantor receives payment from the primary obligor or the debt becomes worthless. While the debt may become worthless at the time of subrogation, as in Putnam, this need not always be the case.47

45See cases in note 37 supra. 4652 U.S. 82 (1956). 47Golder v. Commissioner, 1976 T.C. Memo. LEXIS 254, 16. See also GCM 34495 (in considering whether an insurer of municipal debt should be treated as a surety, the IRS held that any payment in the nature of interest undertaken by the insurer would not have the same character as interest (that is, tax-exempt under section 103). The IRS noted in its analysis that a surety is often considered “primarily liable” under commercial law, citing to C.J.S. (“The obligation of a surety in the strict sense is primary, original and direct, and is generally the same as that of the principal.”) and Stearns, Law of Suretyship, (“Suretyship may be defined as a contractual relation whereby one person engages to be answerable for the debt or default of another. Within this broad definition fall contracts of guarantors and endorsers, as well as those of sureties in the restricted sense . . . the surety, using the term in its restricted meaning, is primarily liable to the creditor, while the guarantor and endorser are only secondarily liable.”) See also Zoby v. American Fidelity Co., 143 F. Supp. 763 (1956). (The court held that (Footnote continued on next page.)
Clearly, if that second test (that is, examining for “ultimate liability”) were applied to jointly and severally liable co-obligors, co-obligors would be treated the same as guarantors respecting interest deductions to the extent the co-obligor paid more than its share of the debt. There are two cases that appear to apply the “ultimate liability”

1028 TAX NOTES, August 29, 2005

endorses a note in solido on the maturity of the debt. However, the court reasoned that “even though petitioner was liable in solido on the debt of Furniture and was thus primarily liable to the creditor, he was secondarily liable vis-à-vis Furniture. In other words, though the creditor was free to collect from petitioner without a prior attempt to recover amounts due from Furniture, the petitioner was only secondarily liable because he had recourse against Furniture.”

Both Koppers I and Abdalla look to who bears “ultimate liability” for a debt to determine which party has the requisite primary liability for claiming the interest deduction. However, as the discussion of Mason and the other relevant authorities demonstrate, the ultimate liability test has not been adopted except in those two cases. None of the cases or IRS authorities that address interest deductions by jointly and severally liable co-obligors, other than Koppers I and Abdalla, discuss the resulting right of contribution. The right of contribution is, however, discussed in other areas of the tax law, most notably in the authorities that deny interest deductions to a guarantor or surety on a debt (such as in Golder, supra). In a more recent Tax Court case that addresses the issue of contribution rights and its effect on the analysis of entitlement to interest deductions, Smith v. Commissioner, the Tax Court disallowed an interest deduction to a guarantor and noted that a different result would occur if the person making a payment on a debt is a co-obligor. In a footnote, the court made the following observation:

This result has been called “anomalous” because joint obligors are presumably entitled to contribution against those joint obligors who do not pay their pro-rata share of the liability. However, payments on a debt obligation on which the payor is primarily and directly liable satisfy sec. 163 irrespective of the fact that the ultimate liability on the debt falls on someone other than the payor.

payments made by the insurer did not constitute interest payments, but rather are more like the purchase of some portion of the debt from the note holders. This rationale is consistent with the insurer’s right of subrogation against the primary obligor.


49 Citing Eskimo Pie Corp. v. Commissioner, 4 T.C. 669, 676 (1945), aff’d 153 F.2d 301 (3d cir. 1946) (holding that a shareholder-guarantor of a corporate debt could not deduct interest paid on the corporation’s debt).

5069 T.C. 697 (1978), aff’d 647 F.2d 487 (5th Cir. 1981).

51 Abdalla, 69 T.C. at 707 (1978). Under Louisiana law at the time, a creditor was required to seek payment from the primary obligor prior to seeking payment from any surety, unless the surety had waived its right of “division and discussion.” One manner for the surety to do this was by being bound “in solido” with the primary obligor.

52 See also Sjöwa v. Commissioner, T.C. Memo. 1995-336, Doc. 95-7275, 95 TNT 145-12, rev’d on other grounds, 123 F.2d 190, Doc. 97-24807, 97 TNT 169-6 (4th Cir. 1997) (co-obligor’s cost of a new residence included only her ratable share of the liability due to state law’s right of contribution); Notice 2002-21, 2002-14 IRB 730 (In this notice, the IRS announcing that it will challenge transactions that use a “loan assumption” agreement to claim an inflated basis in assets acquired from another party as being a tax shelter under sections 6011, 6111, and 6112. A promoter typically would market those transactions as creating a permanent tax deduction (either ordinary or capital losses) when a taxpayer became a co-obligor on a loan made to a third party, such as a limited liability company with foreign members. Thus, the transaction created an artificial loss that was used to offset other unrelated taxable income.)


54 Smith, 84 T.C. at n.6 (1985) (citations omitted).
Thus, a preliminary question seems to be whether the right to the interest deduction is based on whether the obligor has “unconditional liability,” as defined in Golder, that is, whether the obligation is contingent on an event such as a default on the debt; or, alternatively, whether the ability to deduct interest turns on whether the obligor will have rights of subrogation against one or more of the other obligors, as was the court’s focus in Abdalla. While the former approach seems consistent with the general rule that tax law follows the economic rights and obligations of the parties, it is generally thought to be the law. Moreover, the Tax Court in Smith flatly rejects the notion that the ultimate liability test should apply. Of course, it is troubling that the courts have not always been consistent in giving interest deductions to the person that is “primarily liable,” as in Abdalla. Perhaps one can distinguish Abdalla in that, as a case decided under Louisiana’s civil code state law principles, it is unique. However, it is difficult to find a meaningful distinction.

Another troubling aspect to the state of the law in this area is the modern tendency to create guarantees that are nearly indistinguishable from joint and several liability in the rights that are provided to the creditor against the guarantor. As a result of the diminishing distinction between a guarantor and a co-obligor, the law in this area has elevated form over substance to a remarkable degree. The Smith court footnote provides extraordinary corroboration in that it is one of the few Tax Court statements to the effect that the form will be respected regardless of the ultimate economics.

Despite the possible elevation of form over substance, as will be seen in the examples below, as long as all of the rights and obligations pertaining to jointly and severally liable co-obligors are observed, there is generally no permanent avoidance of tax. Also, the likelihood for abuse in this area should be somewhat limited given the possible application of section 446, or, in the case of related parties, section 482.

2. The accrual method taxpayer. Virtually all of the case law permitting co-obligors to deduct interest payments according to which obligor made the payment have addressed situations in which the obligors have been cash basis taxpayers. Unlike cash basis taxpayers, accrual basis taxpayers deduct interest in the year in which it accrues, not in the year in which it is paid. Generally, interest accrues — and thus is deductible — when all events have occurred that determine the fact of liability, the amount of the interest can be determined with reasonable accuracy, and economic performance has occurred. Economic performance occurs when the interest economically accrues with the passage of time, as the obligor uses, and the creditor forgoes the use of, the creditor’s money.

That raises the question of how accrual basis taxpayers that are jointly and severally liable on a debt should accrue interest. It would seem unlikely that accrual basis co-obligors would be permitted to simultaneously deduct the full amount of annual interest. One would think such an approach would be particularly susceptible to the section 446(b) “clear reflection of income” challenge suggested by the Mason court.

The same issue may arise for cash basis taxpayers that are jointly and severally liable on debt issued at a discount (that is, having OID). The rules applicable to OID generally place cash method taxpayers on an accrual basis, requiring those taxpayers to include OID into income over the term of the debt as it accrues. Again, to permit all co-obligors on OID debt to take the full interest deductions would likely be susceptible to challenge under section 446(b).

Arguably, in the accrual basis co-obligor context, the courts could hold that only the co-obligor that has received the loan proceeds should be entitled to the deductions, but that would run counter to the existing law discussed above, which ignores which party had the use of the proceeds. One arguably reasonable method for non-OID debt would be for the obligors to adopt a cash basis approach to the interest deductions (that is, whichever obligor pays in any given year gets the deduction).

Alternatively, the co-obligors could use the noncontingent bond method to determine eligibility for the interest deductions. Because for any given co-obligor, it is not certain how much interest that co-obligor will pay over the term of the debt, each co-obligor could use the noncontingent bond method to determine the amount of interest to accrue in each accrual period. Under that method, the taxpayer would construct a projected payment schedule for the debt instrument based on the terms of the obligation and the yield of comparable noncontingent bonds. If the actual amount of contingent interest is not equal to the projected amount, adjustments would be made to reflect the difference. Presumably, it should be a reasonable approach for OID deductions to be determined under the noncontingent bond method as well.

Another consideration for accrual basis taxpayers is the appropriate timing for including in income the right of contribution that arises when a co-obligor pays more than its share of the debt. The paying co-obligor arguably has accrued the right to the income through performance (that is, making payments in excess of the co-obligor’s share), and should include as income the amount for

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56See, e.g., Miller & Vidor Lumber Co. v. Comm’r, 15 B.T.A. 948 (1929), aff’d, 39 F.2d 890 (5th Cir. 1930), cert. denied, 282 U.S. 864; Rev. Rul. 75-12, 1975-1 C.B. 62.

57Treas. reg. section 1.1275-4(b).

58Treas. reg. section 1.1275-4(b). Thus, if interest is contingent on a future event, it cannot accrue before the event takes place and the liability to pay becomes fixed. Natco Corp. v. United States, 240 F.2d 398 (3d Cir. 1956); Rev. Rul. 70-367, 1970-2 C.B. 37.

59See generally section 1272(a)(1).

60See generally Treas. reg. section 1.1275-4(b).
which the right of contribution is created.\textsuperscript{61} That is an argument the IRS made in the second \textit{Koppers} case, \textit{Koppers Co. v. Commissioner} (\textit{Koppers II}),\textsuperscript{62} although the argument was moot because the court ultimately found that the taxpayer did not pay more than its share of the interest, and, thus, did not have any contribution rights against any others.

Generally, “income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.”\textsuperscript{63} The right to receive income is typically fixed on the earliest of (1) the taxpayer’s receipt of the payment, (2) the contractual due date, or (3) the taxpayer’s performance.\textsuperscript{64} Without agreement between co-obligors, common law is not entirely clear as to when a right of contribution actually becomes fixed, especially with respect to the payment of interest. For instance, does a right become fixed when interest is timely paid during the term of the debt or does it become fixed only at maturity of the debt? Or does it become fixed during the term of the debt once a co-obligor pays more than its fair share of all payments due? Further, common law is unclear as to whether a co-obligor must pay more than its proportionate share of both interest and principal before acquiring a right of contribution.

\textit{Restatements (First) of Restitution} says: “The cause of action for contribution arises and arises only when the payor has paid more than his share . . . if the debt is due at the time of payment. . . . Where payment is made before maturity, the payor is entitled to contribution at maturity.”\textsuperscript{65} Accordingly, if one of two co-obligors has paid more than its proportionate share of the entire debt — both interest and principal (and such payment was made at maturity) — that co-obligor should arguably be treated as having completed the performance necessary to give rise to a right of contribution, although the right to contribution does not actually come into existence until the debt matures. By contrast, until that time when a co-obligor has paid the maximum aggregate amount of its proportionate share of the debt, it is unclear whether such co-obligor has paid (or will pay) enough to be entitled to a right of contribution under the debt.

For example, assume A and B each obtain $50 under a debt for which they are jointly and severally liable, interest is 10 percent per year, with a five-year maturity. Assume further that no agreement exists allocating the burden of annual interest payments, and that in Year 1, A pays the full $10 of interest. While arguably A has an immediate right of contribution because A has paid more than its proportionate share of interest in the first year, commercial law is unclear as to whether that right has in fact become fixed. For instance, B might pay $10 in Year 2, in which case neither party should have a right of contribution against the other, or alternatively, each could have an offsetting right of contribution against the other. Thus, arguably, it is reasonable to wait until maturity of the debt before determining which co-obligors will have rights of contribution against other co-obligors. Of course, such an approach does not take into account the time value of money. Because of the time value of money, their rights of contribution will not be exactly offsetting. If both A and B are treated as having a right of contribution, A’s right should be more valuable than B’s because common law imposes interest on a right of contribution.\textsuperscript{66}

An exception to the rule that a right of contribution should be fixed only at maturity might be proposed when a co-obligor has paid more than its maximum aggregate fair share before maturity. For example, assume there are two equal co-obligors on a note that requires that the full interest and principal be amortized over 20 years with $100 payments per year. In those circumstances, if one co-obligor, A, pays $100 per year for the first 10 years, any additional payments made by A would arguably entitle it to a right of contribution because the other co-obligor, B, could never pay enough under the debt to be able to pay its proportionate share of the debt. Because the payments during the first years of an amortizing loan consist primarily of interest, A would have overpaid interest and underpaid principal relative to B. In such a case, an alternative view would be that A has a right of contribution for interest but not for principal, and that B has an offsetting, or partially offsetting (due to the time value of money), right of contribution for principal. That same analysis arguably applies if one co-obligor receives all of the proceeds of the debt (assuming a right of contribution arises based solely on which party receives the benefit of the debt) — any amount paid by the other co-obligor should eventually result in a right of contribution.\textsuperscript{67}

Additionally, if a co-obligor is required to comply fully with all of its obligations under the debt instrument (which may include restrictions such as paying dividends, borrowing, or paying interest on more junior debt) in order to claim a right of contribution, in most situations the co-obligor will be required to fully perform until final maturity of the debt to obtain a right of contribution. Moreover, creditors will often require that rights of contribution not be enforceable until maturity of the debt so as to avoid competing claims against the ultimate debtor.

Thus, a principal issue in the analysis should be whether continued performance under the agreement of indebtedness is required for a party to claim a right of

\textsuperscript{61}Under this theory, the taxpayer would have an account receivable for the right of contribution and would be entitled to a deduction on showing that the receivable is worthless or uncollectible.

\textsuperscript{62}11 T.C. 894 (1948).

\textsuperscript{63}Treas. reg. section 1.446-1(c)(1)(ii).


\textsuperscript{65}\textit{Restatement (First) of Restitution}, section 82 (1937).

\textsuperscript{66}See note 22 supra.

\textsuperscript{67}Under common law, there is support for the proposition that a right of contribution arises when a co-obligor pays more than its proportionate share of all payments required to be made under a debt instrument. See \textit{Kee v. Lofton}, 12 Kan. App. 2d 155, 737 P.2d 55, 59 (Kan. App. Ct. 1987); \textit{Robinson v. Jennings}, 70 Ky. 630 (1870); \textit{Bushnell v. Bushnell}, 77 Wis. 435, 46 N.W. 442 (Wis. 1890).
commercial law, a holder of a right of contribution is entitled to interest on the amount due under that right of contribution, but the interest does not start accruing until the co-obligor has made payments in excess of the co-obligor’s share.70 As discussed above, it will often not be known until maturity or well into repayment of the debt whether a person is entitled to a right of contribution. Moreover, if there are conditions precedent to an entitlement to a right of contribution, it is questionable whether the state law interest would apply at all until all conditions precedent have been satisfied. Even if commercial law does not impose an interest rate, one could argue that a right of contribution should either bear interest or tax principles should impute interest, at least in the case of parties bearing certain relationships, in a manner similar to the imputation rules under section 7872 or section 482. However, it is unclear at which point in time a right of contribution would be considered a debt within the meaning of the tax law, and thus would become subject to imputation of interest.

Another issue is raised by the possibility that co-obligors can contractually agree to waive rights of subrogation, contribution, and reimbursement. It is unclear what tax treatment should apply to any such waiver or substantial contractual modification of a right of contribution. If it were determined from the outset that one of the co-obligors was going to be primarily responsible for making payments on the debt and those payments would be greater than such co-obligor’s proportionate share of the debt, or if under a debt instrument only a small amount were loaned to one of the co-obligors (so that co-obligor was waiving only a potentially small contribution right relative to that being waived by the other co-obligor), there would appear to be a shift of value as between the co-obligors. Alternatively, if the co-obligors are both borrowing substantial amounts and mutually agree to waive any rights of contribution, any value transfers would seem to be offsetting. However, it is difficult to imagine the business purpose of such waivers, and any resulting distortions in taxable income would seem particularly susceptible to challenge under section 446(b) or otherwise. That said, there is no law directly governing the tax consequences of those waivers. Arguably, an analogous authority would be Rev. Rul. 72-2, which would suggest that there should be no adverse consequences if there is truly no abusive plan or arrangement at the start, but the parties are merely agreeing to pool their resources to repay the debt (assuming that each party is responsible for paying at least its allocable share of the principal). The second time-value-of-money issue relates to whether rights of contribution should be traced separately for payments of interest and payments of principal. If no distinction is made, co-obligors could effectively have different costs of capital under the same obligation.

3. Examples. The consequences of the interest deductibility rules for jointly and severally liable co-obligors are explored in the following examples.

68See Lucas v. North Texas Lumber Co., 281 U.S. 11 (1930) (when the buyer of taxpayer’s land gave notice in an executory contract that it would pay the purchase price “as soon as the papers were prepared,” unconditional liability of buyer was not created, and taxpayer, who did not prepare the necessary papers or tender title or demand the purchase price in 1916, did not have income in that year); Decision, Inc. v. Commissioner, 47 T.C. 58 (1966) (when petitioner’s advertising contracts provided that orders placed under the contract were to be billed in January 1964 with terms net 30 days, and petitioner partially performed in earlier year, arrival of 1964 billing date was necessary event to fix right to income); Cox v. Commissioner, 43 T.C. 448 (1965), acq. 1965-2 C.B. 4 (when investment management company’s contracts provided that clients’ payments were due when billed, the unbilled fees were not payable until billed, and to the extent they were not supported by services rendered, they had not yet accrued).

69Cleverleaf Creamery Co., Inc. v. Davis, 97 F. Supp. 121 (N.D. Ala. 1951) (when Defense Department regulations granted subsidy payments to manufacturers of processed butter that complied with certain requirements, submission of claim and its approval were purely ministerial acts that did not affect or delay the right to payment); Rev. Rul. 74-432, 1974-2 C.B. 147 (when stock brokerage house enters into contracts to buy or sell securities at the request of investors, taxpayer accrues commission income at the time of trade and not five days later when sales are recorded and the securities are delivered, because all actions after the trade are of a ministerial nature and are merely in confirmation of the trade).

70See note 21 supra.
Example 1. Assume a partnership (P) owns 100 percent of the stock of two domestic corporations (A and B), both accrual method, calendar-year taxpayers that are jointly and severally liable co-obligors on a $1 million note payable to an unrelated party bearing 10 percent interest per annum, each co-obligor received 50 percent of the loan proceeds, and there are no preagreed arrangements regarding repayment of the note or to rights of contribution. In Year 1, A pays all $100,000 of interest.

Under commercial law, A and B are presumed to be equal co-obligors. Whether A would have an immediate right of contribution or a right of contribution only on repayment of more than 50 percent of all interest and principal on maturity is not completely clear; although under our facts arguably it should be the latter.1 Also, note that under bankruptcy law, A would not have to accrue its right of contribution for $50,000 as income, which would offset $50,000 of deductions. Later, if and when A can establish that its right of subrogation is worthless, A should be entitled to a bad debt deduction.2

The IRS may try to argue that Mason, which involves cash method taxpayers, should not apply. See Koppers II. Under that argument, A must accrue its right of contribution for $50,000 as income, which would offset $50,000 of its deductions. Later, if (and when) A can show that that right of contribution is worthless, A would be entitled to a deduction. Alternatively, the IRS could make the Koppers I argument: that a co-obligor, like a guarantor, cannot deduct interest for which it has a right of contribution. Because A is entitled to a right of contribution for $50,000, A would not be entitled to a deduction (at least until the right of contribution is found to be worthless).3

Example 2. Same facts as Example 1 except that A pays more that its proportionate share of the principal at maturity. A would have no deduction on its proportionate share of the principal, but nonetheless would have a right of contribution against B for B's share of such principal. Presumably, payment by B of such right should result in no income to A and no deduction by B. A's forgiveness of the amount owed by B, as in the case of the right of contribution for an interest payment, should probably be treated as a distribution by A to P followed by a contribution to B by P (although forgiveness in this case would result in COD income among unrelated parties).

Example 3. Note that the tax result differs from Example 1 if A and B had each borrowed $500,000 and provided cross-guarantees on the debt of the other, although economically the difference is arguably immaterial.4 Under those circumstances, A and B would each be entitled to a $50,000 interest deduction in Year 1. If A makes a payment of $100,000 (perhaps because B's cash flow was weak and the creditor pressed A for the payment), B, as an accrual basis taxpayer, would still be entitled to a $50,000 interest deduction, and A should be treated as having made the payment in its capacity as a guarantor. Under commercial law, A would generally have a right of subrogation against B for $50,000, which would arise in Year 1.5 The existence of that right of subrogation generally prevents A from taking an interest deduction as a guarantor.6 If B repays A under A's subrogation right, there should be no income to A and no further deduction to B. Alternatively, if and when A can establish that its right of subrogation is worthless, A should be entitled to a bad debt deduction under section 166.

The end result in Examples 1 and 3 are economically very similar if B later pays $50,000 over to A. In both cases, both A and B will receive a $50,000 deduction, however, the timing could be quite different. What becomes evident is that, if current case law continues to be valid, joint and several liability allows the parties to potentially shift the interest payments and the timing of deductions among the co-obligors.

71Also, note that under bankruptcy law, A would not have a right of contribution, but only a right of subrogation.

72The IRS may try to argue that Mason, which involves cash method taxpayers, should not apply. See Koppers II. Under that argument, A must accrue its right of contribution for $50,000 as income, which would offset $50,000 of its deductions. Later, if (and when) A can show that that right of contribution is worthless, A would be entitled to a deduction. Alternatively, the IRS could make the Koppers I argument: that a co-obligor, like a guarantor, cannot deduct interest for which it has a right of contribution. Because A is entitled to a right of contribution for $50,000, A would not be entitled to a deduction (at least until the right of contribution is found to be worthless).


74This might be the case under the common law rule in note 21 supra.
Example 4. Same facts as in Example 1 except A pays $100,000 in March of Year 1 and B pays $100,000 in April of Year 1. Arguably, A would be entitled to the $100,000 interest deduction because the first amounts paid should be treated as interest paid on the loan, and B would be treated as having paid down $100,000 of principal. Alternatively, because both A and B are accrual basis taxpayers, and there has been economic performance and equal payment by both in the same year, they should each receive the same $50,000 deduction. If the former approach were adopted, A and B would each have a $50,000 right of contribution against the other: A’s right of contribution against B, when paid, would be income to A and deductible by B, and B’s right of contribution against A, as in example 2, should give rise to no income or deduction when paid. Alternatively, the rights of contribution could offset one another, leaving A with the deduction when paid. Alternatively, the rights of contribution against the other: A’s right of contribution against B, when paid, would be income to A and deductible by B, and B’s right of contribution against A, as in example 2, should give rise to no income or deduction when paid. Alternatively, the rights of contribution could offset one another, leaving A with the deduction when paid. Alternatively, the rights of contribution against the other: A’s right of contribution against B, when paid, would be income to A and deductible by B, and B’s right of contribution against A, as in example 2, should give rise to no income or deduction when paid. Alternatively, the rights of contribution could offset one another, leaving A with the deduction when paid.

Example 5. Same facts as in Example 1, except the debt amortizes over a 10-year period with constant payment amounts throughout, and A expects poor cash flow over the first five years of the debt, while B expects solid cash flow throughout. Accordingly, A and B agree that B will service the debt during the first five years and A will service the debt during the second five years, so that each will have paid the exact same dollar amount.

Under commercial law, arguably, neither A nor B should have any rights of contribution against the other because both have paid exactly the same amounts. However, there are two elements of distortion here. First, A derives a significant time-value-of-money benefit without having to compensate B for it. Second, given the amortization of the debt, B will have substantially greater interest deductions than A. Arguably, B’s greater interest deductions serve as partial compensation for B’s time-value-of-money cost, but unless there is some adjustment to address these two elements of distortion, it would seem that a challenge under section 446(b) or otherwise would be possible.

Most of these examples show that, if the implications of the rights of contribution are followed through to their natural conclusions, there is no permanent avoidance of taxable income; however, there is clearly the ability to substantially affect (or, perhaps in the eyes of the IRS, manipulate) the timing and location of deductions.

Example 6. Assume P is buying corporations A and B from the same seller for $15 million each in a reverse subsidiary merger for each of A and B. P uses $10 million of its own cash in the purchase and, the two transitory merger subsidiaries will be jointly and severally liable for $20 million of borrowed proceeds; A and B will become jointly and severally liable for the debt after the mergers. Assume the borrowed cash goes directly from the lender to the seller so that it is unclear the extent to which borrowed proceeds have funded the two purchases. Also, A and B mutually waive any rights of contribution for interest payments.

It turns out that A’s cash flow exceeds expectations and B’s cash flow falls short. Accordingly, A makes most debt payments (nearly all of which are interest payments). P sells A and the sale proceeds are sufficient to retire the full debt.

First, because the borrowed proceeds will be treated as redemption payments, an allocation of the debt will be necessary to determine P’s basis in the stock of each of A and B. While there should be some flexibility in allocating the debt, at a minimum, debt-to-equity considerations should become a factor (for example, in the extreme case, allocating $15 million of the debt to one of the target entities would likely not be respected). We will assume here that the debt is allocated $10 million to each of A and B, giving A a basis of $5 million in each of A and B.

Second, while a mutual waiver of rights of contribution is arguably analogous to cross-guarantees, the similarity is not compelling and it is difficult to imagine the business purpose for such a waiver. Accordingly, such a waiver of contribution rights would likely be susceptible to challenge by the IRS under section 482 or 446(b). Query, however, whether Rev. Rul. 72-2 would allow A to keep all of the interest deductions?

If the form were respected, there would be two distortions. First, A will have born all of the economic burden of the interest payment, and, while it may be appropriate (at least under the Mason line of cases) for A to get the interest deductions, it seems inappropriate for B to bear the unreimbursed cost of B’s redemption (the purpose for which the debt was used by B). Accordingly, some sort of correlative adjustment should probably be made as A pays more than its share of the interest (for example, deemed dividend to P and capital contribution to B).

Second, the retirement of the debt on the sale of A is again using value in A to fund B’s redemption. If the form is respected, P’s gain on the sale of A would be depressed, while the built-in gain on B would be increased by $10 million as B’s debt vanishes, resulting in a shift in gain taxation from A to B. Accordingly, the right result should be a deemed distribution by A to P followed by a contribution by P to B.

B. Section 108

"Gross income means all income from whatever source derived, including (but not limited to) ... income from discharge of indebtedness." 79 The question is how that rule applies to the discharge of indebtedness for which there are jointly and severally liable co-obligors. The answer, as described more fully below, is that only a co-obligor that "receives a nontaxable increase in assets" as a result of the indebtedness should have income from the discharge of that indebtedness. That creates a focus on tracing the proceeds of the borrowing, rather than on the nature of the obligation.

The discharge of guaranteed debt can result in COD income only to the primary obligor; it does not result in COD income to the guarantor, even if the guarantor has become primarily liable as a result of the default of the primary obligor. The seminal case in this area is Landreth.

79Section 61(a)(12).
liable'" as compared to a guarantor, that does not seem to be an
without further inquiry because such an obligor is "primarily
jointly and severally liable co-obligor could have COD income
basis that the taxpayers in

distinguishes
Landreth v. Commissioner, 50 T.C. at 813.

there are no cases that directly address how to
determine COD income for joint and severally liable
co-obligors when those co-obligors are being discharged
from their liabilities under the shared indebtedness, the
Landreth rationale seems sufficiently analogous that one
could reasonably conclude that the co-obligor that re-
cived the direct proceeds of the indebtedness would
have COD income on discharge, subject to statutory
exceptions under section 108 or judicial exceptions (such
as that created in the Commissioner v. The Rail Joint Co.\textsuperscript{82} case). Thus, any co-obligor not entitled to a right of
contribution against the other co-obligors (because it is
considered the "primary" or "principal" obligor under
commercial law) should be the co-obligor required to
include COD income on the forgiveness of a multi-
obligor debt with jointly and severally liable co-
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It would clearly seem inappropriate for a discharge of
all co-obligors to result in COD income to be double
counted, and there appears to be some support for that
position. In Chief Counsel Advice 200023001 (Feb. 4,
1999), Doc 2000-16151, 2000 TNT 113-67, the IRS provided
the following sensible analysis in support of such a view:

Because a taxpayer has a pro rata right of contribu-
tion from each of the co-obligors under certain
circumstances, discharge of all of the co-obligors of
the full amount of a joint and several obligation by
a creditor should not be treated as income to each
co-obligor in the full amount of the discharged
obligation under section 61(a)(12). See Kahle v. Com-
missioner, T.C. Memo. 1997-91 (suggesting that the
amount of cancellation of indebtedness income to a
debtor in bankruptcy that gives rise to attribute
reduction may be reduced because certain of the
discharged debts were joint liabilities); Bressi v. Com-
missioner, T.C. Memo. 1991-651 (finding that the
amount of discharge of indebtedness income for two
taxpayers with joint and several liability for
indebtedness was equal to the total amount of
indebtedness discharged); Rev. Rul. 92-97, 1992-2
C.B. 124 (determining that the amount of discharge
of indebtedness income for a partnership and two
jointly and severally liable partners is equal to the
total amount of indebtedness discharged). Rather,
an appropriate allocation of the discharged indebt-
edness should be made between the co-obligors,
based on all the facts and circumstances.

One other distinction in the COD context is worth
noting. Section 108(a)(1) provides that COD income will
not be includible in gross income to the extent the
taxpayer is insolvent. In determining whether a taxpayer
is insolvent, guarantees made by a taxpayer are generally
not taken into account because the court will typically not
take an obligation into account in determining a tax-
payer’s insolvency unless, as of the calculation date, it is
more probable than not that he will be called on to pay
that obligation in the amount claimed.\textsuperscript{84} While it is
unclear whether such a test should apply to an uncondi-
tional obligation such as that of a co-obligor, it would
seem to be a sensible approach.

C. Liability Shifts Among Co-Obligors

Another area in which there are interesting issues
related to joint and several liability is when there is a
liability shift, either through the assumption of a debt
from a jointly and severally liable co-obligor or through
the creation of a joint and several liability through the
addition of a co-obligor that will be jointly and severally
liable on the debt. In addition, the tax implications of
deleting a co-obligor should be considered.

\textsuperscript{80}50 T.C. 803 (1968).
\textsuperscript{81}Landreth v. Commissioner, 50 T.C. at 813.
\textsuperscript{82}61 F.2d 751 (2d Cir. 1932); Fashion Park, Inc. v. Commissioner, 21 T.C. 600 (1954). Payment by the principal debtor
does not increase the guarantor’s net worth; it merely prevents it, pro tanto, from being decreased. The guarantor no more realizes income from the
transaction than he would if a tornado, bearing down on his home and threatening a loss, changes
course and leaves the house intact.\textsuperscript{81}

\textsuperscript{83}There is one case that holds taxpayers liable for discharged
debt on the basis that the taxpayers were primarily liable
without considering if taxpayers received a nontaxable increase
in assets because the court did not consider the note).

\textsuperscript{84}Merkel v. Commissioner, 109 T.C. 468, Doc 98-461, 97 TNT
251-14 (1997), aff’d, 192 F.3d 844, Doc 1999-30468, 1999 TNT 182-7
(9th Cir. 1999).
1. Addition of co-obligors in a taxable transaction. Under Treas. reg. section 1.1001-2(a)(1), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. The regulations go on to provide that the sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability). The application of that rule to jointly and severally liable co-obligors can best be explored with some examples.

Example 7. Corporation A acquires a $50 piece of property with $10 of cash and a $40 recourse indebtedness secured by the property. A later transfers the property to unrelated party B, and B pays $10 to A and assumes the debt; A remains an obligor on the debt. Treas. reg. section 1.1001-2(a) would require A to include in the amount realized the full amount of the $40 debt because the property securing the debt being assumed has been transferred. Interestingly, while the amount is included as an amount realized for purposes of determining A's gain, the transaction does not constitute a "significant modification" of the debt as long as there is no change to the payment expectations.

Example 8. Same facts as in Example 7 except A sells property other than the property securing the debt to B, B assumes the debt as consideration, and A remains an obligor on the debt. (That would be similar to a situation in which B assumes unsecured debt of A in connection with a property transfer and where A remains liable on the debt.) Again, the transaction does not constitute a significant modification of the debt as long as there is no change to the payment expectations. The consequences to A, or what they should be, are less clear.

It is likely under the facts in Example 8 that the addition of B as a co-obligor constitutes an assumption of A's debt for purposes of determining the amount realized on the transaction. Technically, Treas. reg. section 1.1001-2(a) does not expressly treat the addition of B as an obligor as a discharge of the debt because there has been no transfer of property securing the debt. Presumably, however, as between A and B, there would be a clear understanding that B would be primarily responsible for repaying the debt, and, given A's potential rights of contribution or subrogation that would exist in the event of any repayment by A, a fair argument could be made that the liability has been assumed for purposes of determining the amount realized. In addition, there is case law to support that view. In Rosen v. Commissioner, the shareholder-contributor recognized gain under section 357(c) even though he remained personally liable on the assumed liabilities, which the transferee corporation was unlikely to pay because the corporation was insolvent. In reaching its conclusion, the court stated "there is no requirement in section 357(c)(1) that the transferor be relieved of liability." The same analysis should arguably apply under section 1001 in a taxable transaction.

However, there is case law that would support the argument that the amount realized should only be taken into account as the debt is repaid by B, thus actually relieving A of that liability. One case worth mention in this regard is Maher v. Commissioner. In Maher, amid a relatively complex set of transactions, a corporation assumed liability for a debt of the shareholder, although the shareholder remained secondarily liable on the debt. The Tax Court treated the assumption as a deemed dividend under a section 304 analysis; the Eighth Circuit reversed, and held there was no dividend income until the corporation actually made payments on the assumed debt, reasoning:

Dividends have been deemed received when the taxpayer has received an economic benefit as a result of a payment made to him or for his benefit by a corporation. An assumption, reduction or cancellation of a liability of a taxpayer by a corporation, to be sure, may give rise to the requisite "economic benefit." The underlying theory of a realization of income under these circumstances is the freeing of the debtor's assets from liability for the debt. Hence the general rule is that there is no income unless and until there has been a release of liability. In the present case, while Selectivend [the corporation] contractually assumed primary liability on the two notes, taxpayer remained secondarily liable until the notes were actually paid. Whatever "economic benefit" may have accrued to taxpayer from the reduction of his liability from primary to secondary is clearly incapable of being evaluated on an objective basis.

Another case worth mention is Jackson v. Commissioner, in which the taxpayer borrowed funds for use in a joint venture. The taxpayer later transferred the joint venture interest to a wholly owned corporation but remained liable for the debt. The court held:

There is an "amount realized" when the taxpayer receives "a full quid pro quo," "valid consideration," his "money's worth." Crane rests, as does the income tax system as a whole, on the concept of gain. Since Jackson was relieved of no liability and received neither money, property nor other economically significant consideration in exchange for his interest in the joint venture, the requirements of section 1001 for a taxable transfer were not met.

87Treas. reg. section 1.1001-2(a)(4)(i). Treas. reg. section 1.1001-2(a)(4)(ii) also provides that the sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability. However, this report focuses on the recourse aspect of the rule as it is the more common case in which joint and several liability is found.

88Treas. reg. section 1.1001-3(e)(4)(iii), (iv).

89And this is clearly the approach Congress has taken in the section 357 context in the enactment of section 357(d), discussed below in the discussion of nontaxable transactions.


89708 F.2d 1402 (9th Cir. 1983).

89469 F.2d 225 (8th Cir. 1972).

TAX NOTES, August 29, 2005 1035
In effect, the court held that when a transferor of property and debt remains liable on the debt, the taxpayer has no amount realized in the transaction for section 1001 purposes.

Of course, since Jackson, the Ninth Circuit has questioned the extent to which it would continue to follow its own decision in Jackson. In Owens v. Commissioner,91 the Ninth Circuit pointed out that in Commissioner v. Tufts92 the Supreme Court largely abandoned its “economic benefit” analysis that supported the earlier Crane decision and was part of the support for the Jackson decision. However, it is not clear what bearing the Tufts decision should have on whether the fact pattern in Example 8 should result in immediate taxation. Arguably, Tufts should be distinguishable because it considered nonrecourse debt.

The real issue here is one of timing. If the liability is treated as having been assumed at the closing, the amount realized is taken into account immediately. Alternatively, the amount assumed could be taken into account as the debt is actually paid by B. Although, consistency would suggest that B does not get basis until it pays the debt. It is unclear which approach provides the better answer from a policy perspective. While Treas. reg. section 1.1001-2(a)(4) clearly adopts the view that if debt is assumed in connection with the transfer of property securing the debt, the amount realized is immediate — irrespective of whether the transferor remains liable on the debt. Extrapolating from that rule, one would argue the treatment should not be any different merely because property securing the debt (as opposed to other property) was transferred.

From the transferor’s perspective, however, the transaction is almost indistinguishable economically from an installment sale in which the transferor would use the installment sale payments to pay its creditor (although on a bankruptcy of the transferor, the creditor would certainly fare worse in the installment sale scenario). Thus, for the same policy reasons that give rise to installment sale treatment, one should be able to treat the transaction described in Example 8 in the same way as though A had sold the property to B for an installment note, and support for such a position can be found in the case law (that is, Maher and Jackson), although the authorities are mixed.93

Example 9. Corporation A and related corporation B each acquire $50 assets for $10 of cash (each) and indebtedness of $80 for which A and B are jointly and severally liable; the assets secure the debt. After A’s asset has appreciated in value to $80, C acquires A’s asset (still securing the debt) and assumes the obligation to repay the entire debt as consideration for A’s asset; both A and B are released from liability.

A should probably include the full $80 into income under Treas. reg. section 1.1001-2(a)(4). B should not have income, because that would be double counting the debt assumption. However, A should have a right of contribution against B. That would be consistent with a transaction in which C borrows $80, uses the cash to buy A’s asset and A repays the entire debt resulting in a fully taxable sale to A and leaving A with a right of contribution against B for $40. For the creditor, this transaction is a significant modification of the debt because there is a substitution of an obligor not qualifying for one of the exceptions to significant modification (assuming A has not transferred substantially all of its assets to C in the transaction).94

That said, there is an argument to be made that A should not have to include B’s portion of the debt into income under Treas. reg. section 1.1001-2(a)(3), which provides: “In the case of a liability incurred by reason of the acquisition of property, this section [1.1001-2] does not apply to the extent that such liability was not taken into account in determining the transferee’s basis for such property.” However, such an interpretation of the regulations would seem unreasonable. First, that portion of the debt that was incurred for B to acquire its asset should probably not be treated as a liability incurred by A for the acquisition of property by A. More fundamentally, though, alternative tax consequences do not seem appropriate (for example, B should have gain or C should not get an $80 basis, neither of which seems appropriate).

Example 10. Same facts as in Example 9 except that when A transfers the property to C and C assumes the obligation to repay the entire debt, A and B remain liable on the debt (assume B’s property continues to secure the debt). The transaction should arguably have the same results as in Example 9 except that now C should be considered primary obligor (such that any amounts paid by A or B would result in rights of contribution against C). From the creditor’s perspective, the transaction in Example 10 results merely in the addition of an obligor to a debt, which would not be a significant modification of the debt if there is no change to the payment expectations.

Note that if A had transferred assets other than the asset securing the debt, the tax consequences to A are closer to those in Example 8 above (that is, immediate recognition of gain or delay in the amount realized until payment of the debt by the transferee under Maher). One of the anomalous results of the law in this area — to the extent there is clarity in the law — is that taxpayers can get substantially different results with virtually identical economics. For example, why should Example 8 be taxed differently than a situation in which the buyer does not assume the liability but instead issues an installment note to the seller, who uses the installment note payments to retire the original debt? Of course, if one agrees that the two transactions should be taxed similarly, one has to ask why a different result applies when property is transferred subject to a debt and the transferor stays liable. Again, the transferor is still liable if the property becomes worthless and the buyer insolvent. The transferor could avoid the immediate tax if it were to provide substitute collateral (not a significant modification if there is no

9181 F.2d 832 (9th Cir. 1989).
93See, e.g., Rosen, supra note 88.
94Treas. reg. section 1.1001-3(e)(4)(i).
change to payment expectations), and transfer the property that previously secured the debt in exchange for an installment obligation. Alternatively, the transferor could have the property released as collateral and the buyer could purchase the property with an installment note, guarantee the original debt, and secure the guarantee with the transferred property.

2. Addition of co-obligors in tax-free transactions. A similar analysis applies in tax-free transactions, although section 357(d) would now apply to govern the consequences. Section 357(d)(1)(A)(ii) provides that a recourse liability (or portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy the liability (or portion), whether or not the transferor has been relieved of the liability. Accordingly, an agreement under which the transferee agrees to pay all or a part of the transferor’s liability, regardless of whether the transferor stays liable, and regardless of whether property securing the liability is being transferred, results in the assumption of that liability (or portion thereof).

At least in the section 357(d) context, in which one cannot argue that the transaction has similar economics to that in an installment note sale, it seems reasonable to have a bright-line rule. Moreover, the transaction is, by definition, permitting a deferral of taxes associated with the liability assumption (subject to liabilities being in excess of basis), so there is not the same punitive effect that can occur under a section 1001 transaction (although, to the extent the debt exceeds the basis of the property, there is the possibility of income). Again, it is primarily a question of timing.

3. Deletion of a co-obligor. The examples above address the considerations of adding an obligor to a liability. There are also tax consequences to consider in the deletion of a co-obligor. When a person is a co-obligor that would be considered to have secondary liability under commercial law, the deletion of such a co-obligor should be treated as the release of a guarantor — that is, there should be no cancellation of indebtedness. That treatment would be consistent with Landreth and Rail Joint, supra.

Conversely, if a co-obligor would be considered the primary obligor under commercial law, and that co-obligor is released from liability, there should be tax consequences to that co-obligor. What those consequences should be depends on the circumstances. For example, assume a subsidiary borrows money and the subsidiary’s parent corporation is a co-obligor (in effect, acting as guarantor). The release of the subsidiary from the liability by the creditor should probably be treated as a capital contribution. Interestingly, however, and as noted above, even though the deletion of a co-obligor may be treated as a recognizeable tax event among the obligors, it would generally not be treated as a significant modification from the creditor’s perspective.

In at least one ruling, the IRS ruled that a parent guarantor of a consolidated group would be considered a co-obligor of debt issued by the group’s finance subsidiary, and thus a release of the finance subsidiary would not constitute a significant modification under Treas. reg. section 1.1001-3. While the IRS did not rule on any other tax consequences on this transaction, presumably the deletion of the finance subsidiary as a co-obligor would be treated as a capital contribution by the parent to the finance subsidiary.

D. Source of Payments

Generally, the source of interest (whether foreign or domestic) under federal law is determined by the residence or place of incorporation of the payor (that is, the issuer of the debt). Payments made by a guarantor of debt are generally treated as though the guarantor has stepped into the shoes of the primary obligor (the look-through principle) and the payments are sourced to the residence of the primary obligor. Thus, if a foreign guarantor of a U.S. obligor’s debt is required to make interest payments on the debt, those interest payments would be treated as U.S. source. However, when a so-called guarantee diverges from the liability with respect to the underlying obligation, the look-through principle no longer applies.

Neither the code nor the regulations directly address the characterization of payments made by U.S. and non-U.S. co-obligors of the same debt. Because neither the method of payment nor the place of payment is relevant in determining the source of interest, various arguments may support different conclusions. For example, based on the case law that gives the co-obligor the benefit of interest deductions, an argument can be made that any payments made by a co-obligor should be characterized in accordance with the payer’s residence. However, analogous to the look-through principle, one could argue that the source of interest payment should be determined by considering whether a payer has a right of contribution against the other co-obligor. In other words,
whether the payer makes the payment as a guarantor. If so, the source would be to the other co-obligor’s residence.

Under Mason, looking solely to the residence of the payer could have interesting results. For example, assume that a U.S. and a Canadian co-obligor are indebted under a note to a U.S. person calling for $50 of interest payments per year by each co-obligor, the co-obligors agree that they will each pay $50 per year under the note, and that they each share equally in the loan proceeds. Assume further there is no agreement on how payments are to be applied. The character and source of the payments, at least under U.S. law, will be determined somewhat arbitrarily by who actually makes the payment.

Thus, if the Canadian co-obligor makes an interest payment of $100 in one year, the U.S. lender would arguably have $100 of foreign-source income (instead of the expected $50 foreign source and $50 U.S. source). What is the appropriate treatment of the U.S. co-obligor’s $50 payment of contribution to the Canadian co-obligor? Is it subject to withholding? There is no law to govern the treatment of that contribution right payment. Clearly, it is worrisome that the payment is deductible (like interest — and would likely not be if it were a contribution right payment respecting principal). However, a fair argument could be made that the payment is merely a reimbursement, and should therefore not be subject to withholding. Moreover, the payment by the U.S. obligor to the Canadian obligor is arguably not a payment for the use or forbearance of money, the classic definition of interest.

IV. Conclusion

What conclusions do we draw from the tax law regarding joint and several liability? Clearly, to the extent that tax law exists to address the different issues that arise in the context of joint and several liability, there does not appear to be a great deal of consistency. There is inconsistency, for example, in the way the rules on deductibility of interest disregard ultimate liability and any tracing of loan proceeds, while the analysis of cancellation of indebtedness consequences flow from exactly those factors. In addition, there is an inconsistency in the interest deductibility rules when the tax consequences applicable to a “secondarily liable” co-obligor are compared to those applicable to a guarantor — although, economically, their roles are virtually indistinguishable in modern commercial practice. Perhaps the appropriate conclusion is that the law should change on interest deductibility. However, the law as it now stands provides great flexibility to taxpayers in meeting the exigencies of unpredictable cash flow, and, if all of the consequences flowing from the rights of contribution are observed, there is arguably limited opportunity for abuse (and sections 446 and 482 should police any attempted abuses).

Regarding liability shifts among joint and several co-obligors, the law seems a bit harsh in requiring a transferor of property to include in the amount realized the full amount of the debt, particularly given the continued exposure the transferor retains. In addition, there seems to be something anomalous about a transaction that does not constitute a significant modification, but that results in a transferor realizing gain based on the full amount of the debt. Finally, the economics are not terribly different from those that occur in an installment sale — for which the policy determination has already been made that deferral is appropriate, and permitted. At least there is case law for taking the position that there is no amount realized until the transferee starts paying the debt.

Finally, in the cross-border context, this report has barely scratched the surface of potential issues (for example, in the case of U.S. parents and controlled foreign corporations, section 956 issues can abound). At the moment, the law is a virtual blank slate. As can be seen in the case of sourcing interest payments by co-obligors, the interest deductibility cases arguably lead to anomalous results. An entire article could probably be written on the cross-border issues alone.