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In this article, Rosenthal argues that Republican presidential nominee Donald Trump aggressively stretched the law to avoid hundreds of millions of dollars of discharge of indebtedness income.

In the early 1990s, Donald Trump owned and operated several casinos and other enterprises that borrowed — and lost — a staggering amount of money. Trump's creditors ultimately bore most of those losses, but Trump himself deducted large amounts of interest, depreciation, and operating expenses.[1]

Trump's losses added up and carried forward to total $916 million of net operating losses by 1995, according to a story published last month by *The New York Times*.[2] And Trump worked hard to protect those NOLs, even when seeking debt relief from his creditors, as the *Times* reported November 1.[3]

Normally, taxpayers do not recognize income when they borrow funds. The logic is that although they increase their assets, their obligation to repay the debt increases their liabilities by the same amount. However, if taxpayers later are relieved of all or part of their obligation to repay, they generally must report the difference as cancellation of indebtedness (COD) income.

Documents filed in the bankruptcy court suggest that Trump aggressively stretched the law to sidestep hundreds of millions of dollars of taxable income from restructuring his public debt. He excluded the income despite reservations expressed by his own lawyers. Had he reported that income, he would have lost about half of his $916 million of NOLs, based on the limited information available to the public. It's unclear whether the IRS ever challenged his position.

Trump's Restructurings

At the time Trump renegotiated his loans, the law allowed several exceptions to reporting income from forgiveness of debt. One permitted a corporation, in limited circumstances, to substitute equity for outstanding debt on the grounds that the corporation was simply changing the form of its obligation to stocks from bonds (the stock for debt exception).[4] Whether or not the stock had any value did not matter for this tax exception.

Some advisers sought to extend the corporate exception, by analogy, to a partnership that exchanged its equity for its outstanding debt (a partnership interest for debt exception).[5] But Trump took this argument even further: He stretched the

[1]Trump's casino debt was nonrecourse, and ordinarily he would be unable to deduct the interest. Section 465. However, Trump's casino debt presumably was qualified nonrecourse financing, which is exempt from those limitations. Section 465(b)(6).

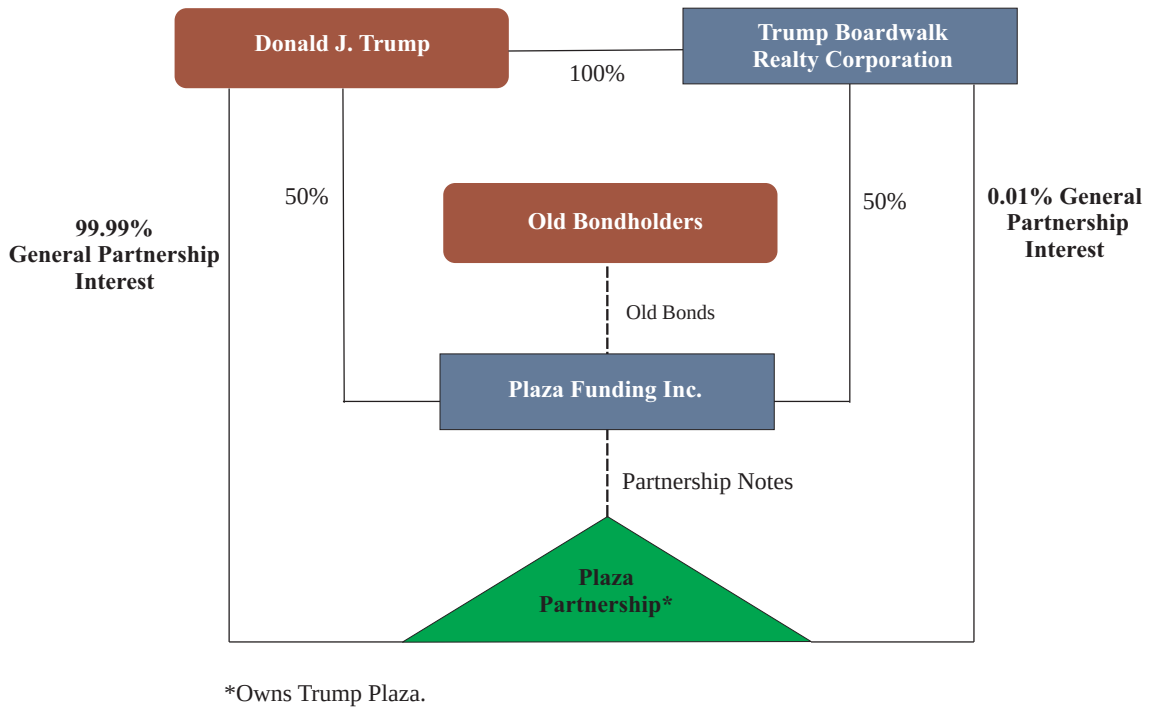
[2]David Barstow et al., "Donald Trump Tax Records Show He Could Have Avoided Taxes for Nearly Two Decades, the *Times* Found," *The New York Times*, Oct. 1, 2016.

[3]Barstow et al., "Donald Trump Used Legally Dubious Method to Avoid Paying Taxes," *The New York Times*, Nov. 1, 2016.

[4]In 1984 Congress limited the stock for debt exception to insolvent or bankrupt corporations. *See* H. Rep. No. 98-861, at 829-830 (1984). In 1993 Congress repealed the stock for debt exception altogether. H.R. 2264, section 13226(a) (the conference agreement for the Omnibus Budget Reconciliation Act of 1993).

[5]*See* New York State Bar Association, "Report on Certain Issues Relating to Troubled Partnerships" (June 28, 1993). Congress itself refused to acknowledge a partnership exception when it repealed the corporate exception. It explained that "no inference was intended as to the treatment of any cancellation of the indebtedness of any entity that is not a corporation in exchange for an ownership or equity interest in such entity." H.R. 2264 at 621. In 2004 Congress expressly "clarified" that a partnership interest for debt exception did not exist. Again, Congress explained that no inference was intended on whether the exception existed under earlier law. *See* Joint Committee on Taxation, "General Explanation of Tax Legislation Enacted in the 108th Congress," JCS-5-05, at 495 (May 2005).

Figure 1. Plaza Casino Before Restructuring



partnership interest for debt exception into a partnership interest for some other entity's debt exception.

Consider what we know about the Plaza casino, one of Trump's three bankrupted casinos in Atlantic City, New Jersey.[6] This casino was owned and operated by Trump Plaza Associates (also known as Plaza Partnership), in which Trump was the 99.99 percent partner. The casino was financed in 1986 by a $250 million bond offering to the public (the old bonds) by a separate corporation, Trump Plaza Funding Inc., which also was directly or indirectly owned by Trump. The old bonds were issued by Plaza Funding, apparently to help the public investors avoid regulation as casino operators under New Jersey gaming regulations, but they were guaranteed by Plaza Partnership.[7]

In 1992 Plaza Funding (and Plaza Partnership) restructured their debt in a prepackaged bankruptcy. The public holders of the original $250 million in bonds received $225 million of new debt (the new bonds) with a lowered interest rate and extended maturity. The public bondholders also got preferred and common stock in Plaza Funding.

However, the steps to accomplish the debt restructuring were somewhat complicated. The public bondholders first exchanged their old bonds for amended notes and preferred interests in Plaza Partnership. Immediately after this exchange, the public bondholders contributed their amended notes and partnership interests for new bonds, preferred stock, and common stock of Plaza Funding.[8]

Up to a point, Plaza Funding and Plaza Partnership followed legal formalities for federal income tax purposes. Thus, Plaza Partnership treated the exchange of the old bonds for amended notes and preferred interest in Plaza Partnership as a partially tax-free transaction under section 721. Plaza Partnership also intended to take the position that its partner, Trump, would not recognize COD income from the reduction in debt in exchange of a partnership interest, regardless of the worth of the partnership interest.[9]

However, Plaza Partnership treated the old bonds as debt of Plaza Partnership for purposes of the partnership interest for debt exception, even though these bonds had been issued and treated by Plaza

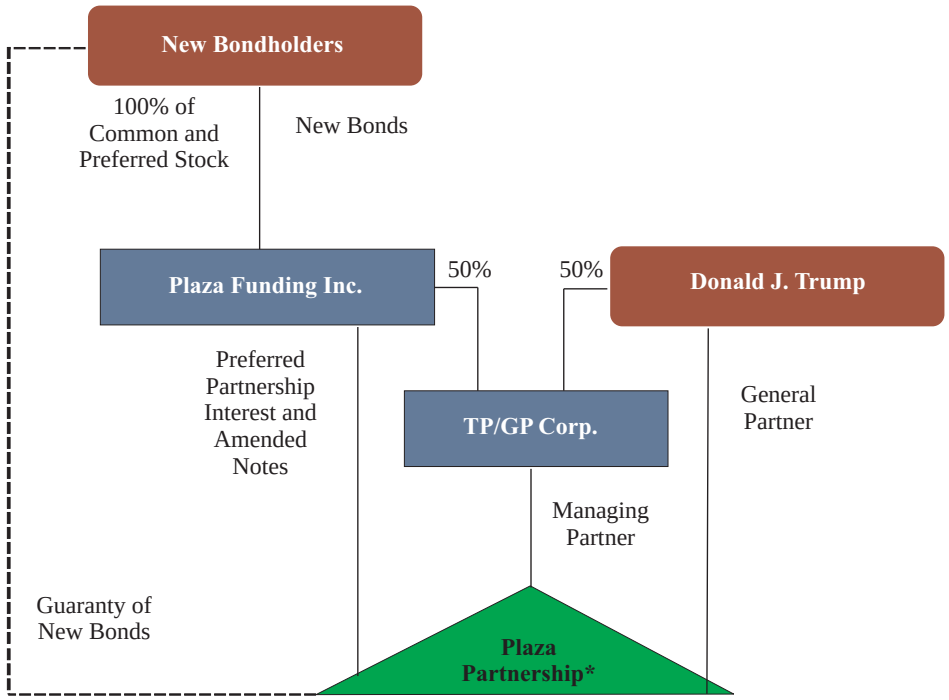
[6]Offering Circular and Solicitation of Plan Acceptances, Trump Plaza Funding Inc. and Trump Plaza Associates, filed Mar. 9, 1992 (Plaza solicitation).

[7]Grant W. Newton and Robert Liquerman, *Bankruptcy and Insolvency Taxation* 138 (3d ed. 2005).

[8]Plaza solicitation, *supra* note 6, at 94.

[9]*Id.* at 100.

Figure 2. Plaza Casino After Restructuring



Funding as its own debt.[10] And Plaza Funding apparently had issued the debt for an important nontax purpose: to help comply with New Jersey gaming regulations.[11] As a result, even if there were such a thing as a partnership interest for debt exception, which was tenuous to begin with, Plaza Partnership stretched the exception into a partnership interest for some other entity's debt exception.[12]

And what if the partnership interest for debt exception did not apply? As explained to the public bondholders, "the Partnership and the current partners [that is, Trump] could recognize substantial cancellation of indebtedness income."[13] That is, the COD income from the restructuring would have been $25 million or so, which is equal to the difference between the adjusted issue price of the old bonds ($250 million, their original face amount) and the issue price of the amended notes ($225 million, unless the bonds were worth less because of a below-market interest rate) — and disregarding the value

[10]In general, taxpayers have been able to assert substance over form only when their "tax reporting and other actions have shown an honest and consistent respect for . . . the substance." *Federal National Mortgage Association v. Commissioner*, 90 T.C. 405, 426 (1988) (citing *Illinois Power Co. v. Commissioner*, 87 T.C. 1417, 1430 (1986)), *aff'd*, 896 F.2d 580 (D.C. Cir. 1990). Curiously, after the restructuring, Plaza Funding planned to treat the new bonds as its own debt once again. Plaza solicitation, *supra* note 6, at 95.

[11]*Cf. Frank Lyon Co. v. United States*, 435 U.S. 561, 583-584 (1978) ("In short, we hold that where, as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.").

[12]Even if a partnership interest for debt exception applied, restructuring might still create taxable income to a partner, at least for a cautious one. A creditor's forgiveness of a partnership's debt triggers a deemed cash distribution from the partnership to the partners under section 752(b). This deemed distribution reduces the partner's basis in his partnership interest under section 733(1), but not below zero. If a partner lacks sufficient basis, he may recognize gain under section 731(a). However, in the early 1990s some advisers asserted that the gain could be excluded under the reasoning of Rev. Rul. 71-301, 1971-2 C.B. 256, which the IRS revoked in 1995. American Bar Association Section of Taxation, "Report of the Section 108 Real Estate and Partnership Task Force," at notes 32, 33 (Aug. 10, 1992).

[13]Plaza solicitation, *supra* note 6, at 21. The bondholders would not recognize the COD income, because they became partners only after the restructuring of the debt.

(Footnote continued in next column.)

of the new partnership equity, which typically would be small for a partnership in bankruptcy.[14]

Trump's other casinos, Taj Mahal and Castle, arranged similar restructurings but with much more potential income at stake. Lenders refinanced $860 million of debt for the Taj Mahal and $336 million for Castle. Of the Taj Mahal's refinancing, $189 million was attributable to four missed interest payments of $47.25 million on its debt.[15] In both the Taj Mahal and the Castle restructurings, the bondholders received new debt worth about a third less than the outstanding debt.[16] Trump's income from the combined discharge of those two debts would have been another $400 million to $450 million or so.[17]

Based on what appears in the bankruptcy papers, the Taj Mahal and Castle restructurings, unlike the Plaza restructuring, had tax opinions from Trump's lawyers. The lawyers asserted that "substantial authority" existed to permit Trump to exclude the income by treating the old bonds as partnership debt.[18] However, the lawyers explicitly refused to give a tax opinion that this position was more likely than not to prevail if the IRS challenged it. That is, Trump's own lawyers estimated his prospects of success at 50-50, at best.[19]

Conclusion

If the IRS successfully disputed Trump's exclusion of income from just these three bond restructurings, it might have eliminated about half of his $916 million of NOLs. And Trump might have begun to pay taxes sooner. We may never know, of course, unless Trump discloses his tax returns, which seems unlikely. ■

[14]From the issuer's standpoint, the old debt is treated as having been retired for an amount equal to the issue price of the new debt, which generally is its fair market value. Section 108(e)(10).

[15]As an accrual method taxpayer, Taj Mahal was able to deduct the interest payments for federal income tax purposes, even though it never actually made the payments, which may have contributed significantly to Trump's NOLs. By contrast, the public bondholders may have stopped accruing the interest, under the doubtful collectibility doctrine. *Corn Exchange Bank v. U.S.*, 37 F.2d 34 (2d Cir. 1930). Congress or Treasury should reconcile these conflicting approaches by adopting a single standard, which could end the accrual of interest "not expected to be paid."

[16]The Taj Mahal and Castle bonds traded on the American Stock Exchange. The initial trading price was $61.50 for Taj Mahal's restructured debt (Oct. 25, 1991), according to data from Bloomberg Finance LP, and $67 for Castle's restructured debt (June 1, 1992), according to data from S&P Global Market Intelligence.

[17]This assumes that the refinanced debts had adjusted issue prices equal to their face amounts, which is almost certainly the case.

[18]In general, if a taxpayer has substantial authority for the tax treatment of an item, there will be no penalties if the IRS successfully challenges the treatment. Reg. section 1.6662-4(d). Substantial authority is an objective standard of law but is less stringent than the more likely than not standard (which is met when there is a greater than 50 percent likelihood of the position being upheld). In the 1990s, advisers typically would issue a "substantial authority" opinion for a position that had about a one-third chance of being upheld if challenged.

[19]Even if a partnership interest for debt exception applied, a restructuring in which a party related to the partnership acquires old or new debt of the partnership could trigger income under section 108(e)(4), which is beyond the scope of my analysis for this article.