Special Federal Tax Rules Relating to Individuals and Other Noncorporate Entities in Bankruptcy

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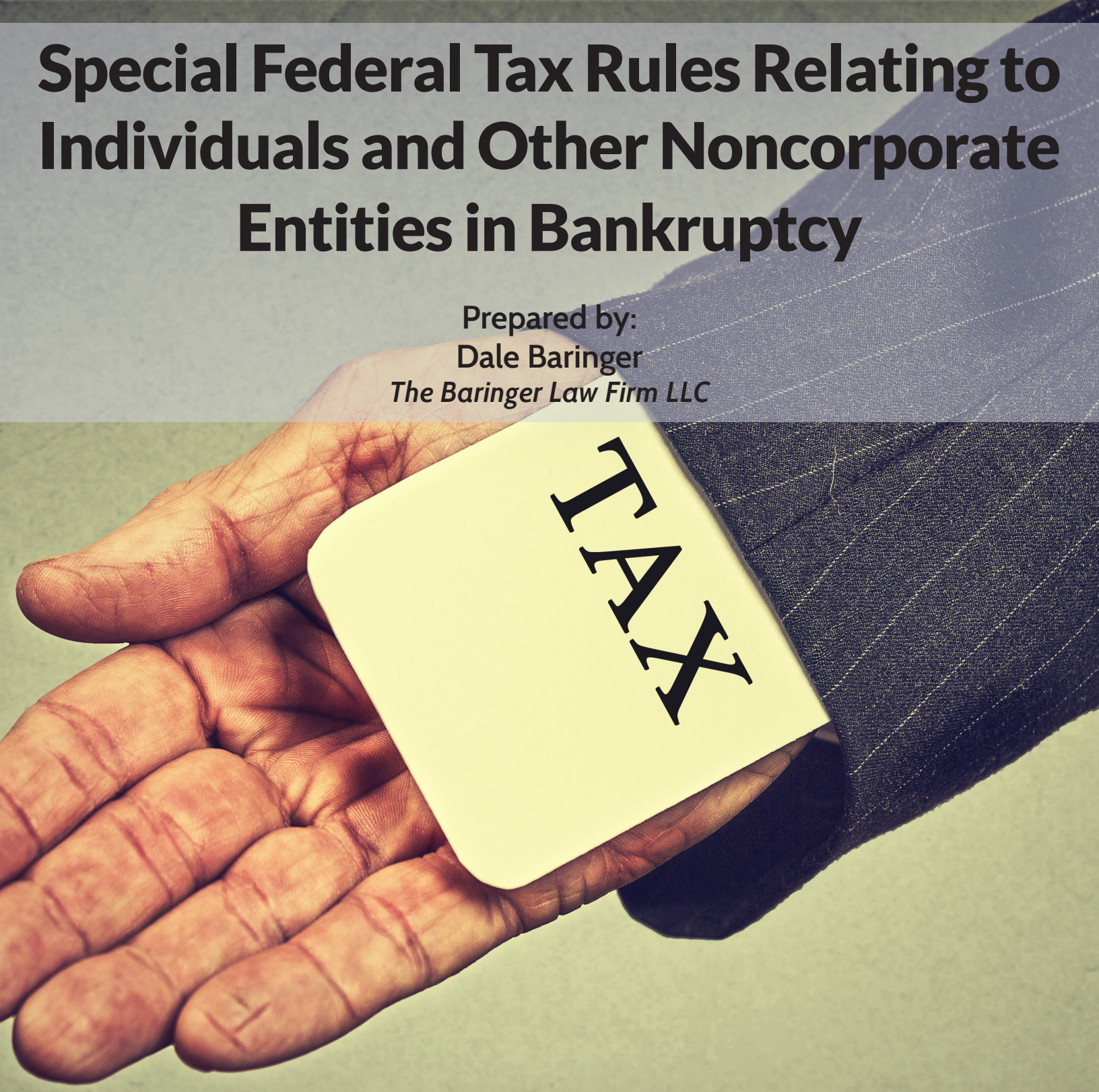

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Special Federal Tax Rules Relating To Individuals And Other Noncorporate Entities In Bankruptcy

A. Computation and Payment of Tax.

1. Filing of Chapter 7 or Chapter 11 bankruptcy petition by an individual gives rise to a separate taxable entity, the bankruptcy estate, which succeeds to the assets, liabilities, and certain tax attributes of the debtor and which is wholly distinct from the individual for income tax purposes. No Separate entity is created upon the commencement by an individual of case under Chapter 13, or in the case of an entity under title 11 (e.g. corporations, partnerships and LLC's). IRC §1398. 26 USCS §1398 contains specific provisions only with respect to cases commenced under Chapter 7 and Chapter 11 of Bankruptcy Code in which debtor is individual; however, 26 USCS § 1399 expressly states that except in any case to which 26 USCS §1398 applies, no separate taxable entity shall result from commencement of case under Title 11 of U.S. Code; accordingly, Chapter 13 estate is not taxable entity under Internal Revenue Code. *In re Whall*, 391 B.R. 1 (Bankr. D. Mass. 2008); *Elkins v United States (In re Elkins)*, 71A A.F.T.R.2d (RIA) 3071 (BC WD Va 1988). In Elkins, the trustee of a Chapter 13 wage earner plan who received $2.5 million in tax refunds representing income tax overpayments by individual debtors was not required to file a tax return for interest on this money because the trustee is not a taxable entity since it is not covered by 26 USCS § 1398; the debtor must file individual tax return covering his share of interest.

a. No separate taxable entity results from commencement of a bankruptcy case involving a partnership, LLC, or corporation. Accordingly, the bankruptcy trustee of a partnership in a bankruptcy case is required to file annual partnership information returns (IRC §6031) and corporate income tax returns. IRC §6012 & §6031 (b)(3); Rev. Rul. 79-120; In re Holywell Corp., 111 S.Ct. 2234 (1992), reversing 911 F.2d 1539 (11th Cir. 1990).

2. Tax is computed in the same manner as for an individual using rates applicable to married persons filing separate returns. The estate receives a personal exemption and, if it does not itemize deductions, uses the basic standard deduction for married filing separate. IRC §1398(c).

3. The transfer from the taxpayer to his bankruptcy estate is not a taxable disposition under 26 USCS § 1398(f)(1). *Williams v. Comm'r*, 123 T.C. 144, 2004 U.S. Tax Ct. LEXIS 33 (T.C. July 22, 2004).

4. The full tax on gain from a post-petition sale of a farm was owed by Chapter 12 debtors outside of plan because Chapter 12 estate was not a taxable entity pursuant to 26 USCS § 1398 and § 1399, and, therefore, estate could not "incur tax" within meaning of 11 USCS § 503(b)(1)(B)(i). *United States v. Hall*, 617 F.3d 1161, 106 A.F.T.R.2d (RIA) 2010-5848, 106 A.F.T.R.2d (RIA) 5848, 53 Bankr. Ct. Dec. (LRP) 145, Bankr. L. Rep. (CCH) P81830, 63 Collier Bankr. Cas. 2d (MB) 1786, 2010-2 U.S. Tax Cas. (CCH) P50566 (9th Cir. 2010), cert. granted, 564 U.S. 1003, 131 S. Ct. 2989, 180 L. Ed. 2d 820 (2011), aff'd, 566 U.S. 506, 132 S. Ct. 1882, 182 L. Ed. 2d 840, 23 Fla. L. Weekly Fed. S 293, 109 A.F.T.R.2d (RIA) 2012-2020, 56 Bankr. Ct. Dec. (LRP) 122, Bankr. L. Rep. (CCH) P82212, 67 Collier Bankr. Cas. 2d (MB) 459, 2012-1 U.S. Tax Cas. (CCH) P50345 (2012).

5. An involuntary bankruptcy case commences upon entry of an order for relief, and not by filing of the involuntary petition, and thus election to close tax year is timely made where it is filed approximately 3 ½ months after entry of order of relief even though involuntary petition had been filed 6 months earlier. *Kreidle v Department of Treasury*, IRS, 146 B.R. 464, 71A A.F.T.R.2d (RIA) 4408 (BC DC Colo 1991).

B. Taxable Year of Debtors and the Bankruptcy Estate.

1. Generally, the taxable year of the debtor is not affected by the filing of a case under Title 11 except that the debtor is allowed an election to terminate his tax year when the case commences. In this case, the debtor files a tax return for the short tax year beginning with the date on which his or her normal tax year begins and ending with the day before the bankruptcy case commences. The individual would then file another return for the period beginning with the commencement date and ending on the last day of the normal tax year of the individual. IRC §1398(d)

2. Tax computed for the first short tax year is an allowable claim against the bankruptcy estate as a prepetition liability. Thus, if there are assets which will be liquidated by the trustee in bankruptcy (i.e. there will likely be funds with which to pay priority claims) strong consideration should be given to making the election. This is particularly true if the taxpayer is self-employed and either has not made his required quarterly estimated tax payments or has otherwise underpaid them. If the bankruptcy estate cannot pay the tax, it is collectible from the individual. An individual with withholding, or who has overpaid on his quarterly estimated payments as of the commencement date generally should not make the election, because if a refund is due, it will become property of the estate.

Where debtor/taxpayers fail to make election to close their taxable year, income tax due for the year in which the bankruptcy case was commenced is considered to be a post-petition obligation and is thus collectible from taxpayers and not from bankruptcy estate, since the individual's taxes are not technically due until end of year. *Moore v. IRS (In re Moore)*, 132 B.R. 533, 71 A.F.T.R.2d (RIA) 4429, 71 A.F.T.R.2d (RIA) 93-4429, Bankr. L. Rep. (CCH) P74220, 1991-2 U.S. Tax Cas. (CCH) P 50390, 91-2 U.S. Tax Cas. (CCH) P50390 (Bankr. W.D. Pa. 1991).

3. If an individual has a net operating loss ("NOL") for the short period ending on the day before the commencement date, this person should not make the election because the NOL will be carried over to the bankruptcy estate and may not be available to offset income of the debtor earned after the commencement date. [See below, Estate Succeeds to Tax Attributes of Debtor. IRC §1398(g)]

EXAMPLE 1: Calendar year T/P files chapter 7 bankruptcy on June 1. He has a $50,000 loss for the period January 1 through May 31, and 60,000 of taxable income for the period June 1 through December 31. If he makes the election to end his tax year on May 31, there will be a $50,000 NOL carried over to the estate's return and, should there be income recognized to the estate from liquidation of assets, the NOL will be used to offset that income. If the T/P does not elect to end his tax year on May 31, the NOL will be available to offset the $60,000 of income earned after June 1.

EXAMPLE 2: (Worse Case): Debtor is attempting to salvage his business which is over-leveraged and losing money rapidly. In urgent need of cash, in the first quarter of 1993 he sells an asset with a low tax basis for a good price and thus generates a large gain. He uses the cash to try to save the business and is not worried about the tax consequences because he has a very large NOL carryover which is available as of the beginning of the year. On September 1, 1993, the Debtor gives up the fight and with the aid of bankruptcy counsel files a Chapter 7 proceeding. Unaware of the opportunity to split the Debtor's taxable year into two separate tax years, Debtor takes no action in this respect, and no election is made. Bankruptcy counsel did not advise Debtor of the opportunity to do so. In February of 1994, Debtor meets with his accountant to go over tax information and learns the NOL is not available to offset the gain recognized in the first quarter of 1993 because it has been transferred to the bankruptcy estate. Therefore, Debtor will have a large post-petition tax liability to begin his fresh start. Had the debtor elected to close his tax year upon the filing date, the NOL would have been available to offset the taxable gain. Will he be able to look to his bankruptcy lawyer for help in paying it?

4. If the debtor is married, the debtor's spouse may join with the debtor in making the election, even if the spouse is not a debtor in bankruptcy. In this case, the spouses must file a joint return for the first short period return. A debtor's spouse who later files a Chapter 7 or Chapter 11 petition in the same tax year as the debtor can make a separate short tax year election, even if the spouse earlier jointly filed with the debtor. The debtor can join in the spouse's election as long as a joint return is filed for the second short tax year ending with the spouse's bankruptcy filing.

EXAMPLE: H files Chapter 7 on March 31 and W files on July 31. H elects to close tax year with his filing and W joins with him. They must file a joint return for January 1 through March 30. W can then elect to close tax year with her filing and H can join with her. They must file joint return for March 31 through July 30. They can then either file separate or joint returns for the short period of July 31 through December

31. If W did not join with H in making the election to file for January 1 through March 30, H cannot join with W in making election to close tax year with her bankruptcy filing because they couldn't have filed a joint return for the period January 1 through July 30.

5. Why is it important for Bankruptcy practitioner to know these rules? Election must be made on or before the due date for filing the return for the first short taxable year - on or before the 15th day of the fourth month following the close of the first short taxable year. In most cases, the debtor may not even see his tax return preparer until long after that date, and then it is too late to make the election.

6. The election to close tax year with filing cannot be made where the debtor has no assets other than property which the debtor may treat as exempt under 11 U.S.C. §522. The election, once made, is irrevocable.

7. The bankruptcy estate's first tax year begins with the commencement date. The estate may elect a tax year other than the calendar year if the requirements for doing so are satisfied. Additionally, the estate is entitled to one change of accounting period without consent from the IRS which would otherwise ordinarily be required under IRC §442. The purpose of this rule is to allow the estate to close its tax year before the expected termination of the estate and effect an expeditious determination of its final tax liability in accordance with 11 U.S.C. §505.

8. Where taxpayer filed for bankruptcy before last day of tax year for two S corporations in which he owned all shares, pursuant to 26 USCS § 1398, losses of corporations for that year flowed to bankruptcy estate, and in no part to him. *Williams v. Comm'r*, 123 T.C. 144, 2004 U.S. Tax Ct. LEXIS 33 (T.C. July 22, 2004).

C. Income, Deductions and Credits of Bankruptcy Estate.

1. Estate includes in gross income: (i) any gross income item of the individual debtor which, under substantive bankruptcy law (11 U.S.C. §541) constitutes property of the bankruptcy estate; and (ii) the gross income of the estate beginning on and continuing after the date the case is commenced. The gross income of the debtor does not include any item to the extent that such item is included in the gross income of the estate. IRC §1398(e).

EXAMPLE: Consultant files Chapter 7 at a time when he is owed a $10,000 fee which has yet to be paid. Pretermitting exemption issue, the fee becomes property of the estate to which the trustee is entitled to receive the payment. This item of income is reported on the estate's income tax return and not on the individual debtor's return.

Note: Care should be exercised to caution debtors that the payor may or may not be aware of the debtor's bankruptcy filing and therefore will likely report the income using the debtor's taxpayer I.D. number. They should be on the look-out for these types of problems. They should be advised to be sure and inform their tax return preparer of the fact that they have filed bankruptcy.

2. See *In re Kochell*, 58 AFTR 2d 86-6082, 804 F.2d 84, (7th Cir. 1986) where Bankruptcy trustee's payment of bankrupt's creditors with assets from individual's IRA account made bankruptcy estate liable for penalty tax on early IRA withdrawals. Although amount distributed from IRA account was attributable to individual's earnings, bankruptcy estate had succeeded to individual's interest in IRA when bankruptcy petition was filed.

3. The estate takes deductions for the normal trade or business expenses which the individual debtor would normally be entitled to, and in addition, the estate is entitled to deduct the administrative expenses of the bankruptcy case. IRC §1398(h).

4. The commencement of a case under the Bankruptcy Code creates an estate which is normally referred to as the Bankruptcy estate. 11 U.S.C. §541. The Bankruptcy estate generally includes all legal or equitable interests of the debtor in property as of the commencement of the case. It also includes proceeds, product, offspring, rents or profits of or from property of the estate; but does not include such as are earnings from services performed by an individual debtor after commencement of the case. 11 U.S.C. §541(a)(6). Thus it has been held that an individual debtor who files a Chapter 11 case as a sole proprietor engaged in the business of providing professional services is entitled to be compensated out of the Bankruptcy estate for his services

rendered post-petition, that such post-petition payments are administrative expenses of the Bankruptcy case and are not property of the Bankruptcy estate when received by the Debtor. In re Herberman, 122 B.R. 273 (Bkrtcy. W.D. Tex. 1990).

Where the estate pays the debtor to continue to operate the debtor's business, these amounts might be considered wages and deductible by the estate as such. §1398(e)(3)(B). This would appear to be the clear implication of applicable IRC provisions and at least the holding in Herberman, supra, however, see Private Letter Ruling 87-28056 where the IRS considered whether withdrawals by a debtor-in-possession were not wages. The bankruptcy estate had treated the debtor, a farmer, as employed and the amounts paid as wages. Citing IRC §1398(e)(3)(B) as authority, the IRS concluded that the amounts were not wages. The basis for this conclusion in the ruling also appears to preclude calling these amounts distributions from the estate for which a Form 1099 is required.

Note that in 2005, 11 U.S.C. §1115 was added to the Bankruptcy Code to expressly provide that earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under Chapter 7, 12, or 13, whichever occurs first, is property of the bankruptcy estate. Also in 2005, 11 U.S.C. §1123(a)(8) was amended to require that, in a case in which the debtor is an individual, the Chapter 11 plan shall provide for the payment to creditors under the plan of all or such portion of the debtor's earnings from personal services performed by the debtor after the commencement of the case or other future income of the debtor as is necessary for the execution of the plan. Thus, after a debtor files for bankruptcy, his future earnings and income are subject to the Bankruptcy Estate by operation of 11 U.S.C.S. §§ 541 and 1115. *In re Breland*, CASE NO.: 1:17-CR-00312-JB, 2019 U.S. Dist. LEXIS 169763; 2019 WL 4786952, (S.D. Ala., 09/30/19)

5. If the bankruptcy case is subsequently dismissed, then the separate entity rules are inapplicable. In this case, the bankruptcy estate ceases to exist and is treated as never having existed. IRC 1398(b)(1); Temp. Reg. Section 7a.2(b). If the case has gone on beyond one taxable year, and the bankruptcy estate had gross income and deductions in those taxable years, the debtor must file amended returns to report the gross income and deductions of the estate. Notice is required to be sent to the IRS service center where the returns for the prior years were filed. If the bankruptcy estate had filed an income tax return, the debtor would be entitled to a refund of the tax paid by the estate. IRS Announcement 81-96 (May 7, 1981), 1981-20 IRB 13.

6. Element of gain on sale by trustee of debtor's personal residence is taxed to the trustee/estate which does not get a deduction or exclusion for payment to debtor of portion of proceeds attributable to homestead exemption. Individual debtor is considered to hold a lien on the property to the extent of his/her homestead exemption. See PLR 91-22042 in which the IRS reversed its position in PLR 90-17075.

D. Estate Succeeds to Tax Attributes of Debtor.

1. The bankruptcy estate can not only use its own generated deductions and credits, it also succeeds to certain tax attributes of the debtor such as the debtor's NOL's, charitable contribution carryovers, recovery of tax benefit items, credit carryovers, capital loss carryovers, basis, holding period, and character of assets, method of accounting, and other attributes to the extent provided in regulations, such suspended passive activity losses and credits, and losses suspended by at risk limitations of section 465.

2. The tax attributes carried over to the bankruptcy estate are subject to reduction pursuant to the rules of IRC Section 108 dealing with income from discharge of indebtedness and the exceptions thereto.

3. Right of the individual under IRC §121 to exclude up to $250,000 of gain from sale of property which has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more during 5 year period ending on date of sale is a tax attribute which carries over to the bankruptcy estate because pursuant to IRC §1398, the taxable income of the bankruptcy estate is to be computed in the same manner as for individuals, therefore the bankruptcy estate steps into the shoes of the individual for the purpose of §121. In re Bradley, 245 BR 533 (M.D. Tenn 1999) held that the gain from sale of an individual Chapter 7 debtor's residence was excluded from gross income of the debtor's bankruptcy estate, to the same

extent that this gain would have been excluded from gross income of the debtor if the debtor had been the taxpayer. The IRS acquiesced in this decision. Acq. 1999-2 CB XVI, 1999-32 IRB 234. In its decision to recommend acquiescence [1999 WL 33100247, AOD-1999-009], the IRS stated that in its view, IRC §1398(c)(1), and (g)(6), when read together, support the bankruptcy estate's claim to the IRC §121 exclusion, finding further support for this result in In re Kochell, 804 F.2d 84 (7th Cir. 1986) (involving the liability of the trustee for the penalty under §408(f)(1) for early distributions from an IRA. This position has now been codified in the Treasury Regulations. Treas. Reg. 1.1398-3(c) provides that the bankruptcy estate succeeds to and takes into account the §121 exclusion with respect to property transferred to the estate. See also *IRS v Waldschmidt (In re Bradley)*, 245 B.R. 533, 85 A.F.T.R.2d (RIA) 463 (MD Tenn 1999).

4. In *Kapila v. United States (In re Taylor)*, Case No. 07-10405-BKC-JKO, Chapter 7, Adv. Proc. No. 07-1644-JKO, 386 B.R. 361; 2008 Bankr. LEXIS 1127; 59 Collier Bankr. Cas. 2d (MB) 1267; 101 A.F.T.R.2d (RIA) 2008-2332, (S.D. Fla. April 10, 2008, plaintiff, the Chapter 7 trustee, filed a Fed. R. Civ. P. 56 motion for summary judgment and defendant United States Government filed a cross motion for summary judgment on an adversary proceeding brought by the trustee to avoid and recover the debtor's election of an irrevocable waiver of a prepetition net operating loss (NOL) carryback under the Internal Revenue Code as a constructively fraudulent transfer, pursuant to 11 U.S.C.S. §§ 548 and 550. The court held that the debtor's prepetition election of an irrevocable waiver of a NOL carryback under the former version of 26 U.S.C.S. § 172(b)(3) was an interest in property under 11 U.S.C.S. § 541 in that the trustee could recover the value of the tax attributes or property, which was not inconsistent with 26 U.S.C.S. § 1398(g); the waiver was a transfer under 11 U.S.C.S. § 101(54) of the debtor's right to a present refund in exchange for the right to deduct the NOL amount from income on future returns; the debtor received less than reasonably equivalent value for the transfer given that there was no objective reasonable chance for the sale of his business to close. The court avoided and recovered from the Government the debtor's election to waive his NOL carryback and carry that tax attribute forward. The court allowed the trustee to apply the prepetition NOL carryback to the debtor's pre-petition tax returns or, by separate motion in the adversary proceeding, seek to recover judgment for the value of the carryback.

* Note that IRC §172(b)(3) was amended by the 2017 Tax Cuts and Jobs Act to eliminate the right to carry back NOLs, limiting their use beyond the current loss year to carryover to future years.

E. Debtor Succeeds to Tax Attributes of the Estate.

1. Upon termination of the bankruptcy proceeding, the debtor succeeds to the tax attributes of the estate at the time of termination. Note that these attributes, to the extent they may have emanated from the debtor's prepetition activities, will likely have suffered substantial reduction by virtue of IRC 108(b) reductions for indebtedness discharged in the bankruptcy case.

2. For purposes of 26 USCS §1398(i), the Chapter 11 bankruptcy estate "terminates" at the time of confirmation of plan of reorganization and not upon entry of final order closing bankruptcy proceeding. *Benton v. Comm'r*, 122 T.C. 353, 2004 U.S. Tax Ct. LEXIS 20 (T.C. May 12, 2004). However, the Tax Court declined to attempt to establish "bright-line rule" under which all Chapter 11 bankruptcy reorganizations would "terminate," within meaning of 26 USCS § 1398(i), at time of plan's confirmation, but noted that circumstances of each case should dictate whether "termination" has occurred.

3. Upon dismissal of a bankruptcy case, §1398 does not apply, and estate is not treated as separate entity such that debtors are subject to tax on gains from property sold during pendency of bankruptcy case but prior to dismissal. *In re Stahley*, 80 A.F.T.R.2d (RIA) 7841, 80 A.F.T.R.2d (RIA) 97-7841, 1990 Bankr. LEXIS 2978 (Bankr. D. Colo. Apr. 6, 1990). The bankruptcy estate loses its status as a separate taxable entity at the moment the Bankruptcy Court judge signs an order of dismissal. Taxpayers are required to recognize gain realized on sale of farm machinery that took place after signing of the order of dismissal but 2 days before entry of order on docket

F. Treatment of Transfers Between Debtor and Estate.

1. Transfer of assets from the individual debtor in a Chapter 7 or Chapter 11 case, to the bankruptcy estate (other than by sale or exchange) is not considered a disposition of the assets for tax purposes, and thus, does not trigger recognition of gain or loss. IRC §1398(f)(1). A transfer of an installment obligation to the estate does not accelerate the gain under installment sale reporting rules. Likewise, "in the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition for purposes of assigning tax consequences to the disposition, and the debtor shall be treated as the estate would be treated with respect to such asset. IRC §1398(f)(2).

2. In the sale or exchange of property, a taxpayer is chargeable with income on the excess of the amount realized over the adjusted basis. 26 U.S.C. §1001(a). Foreclosure of a mortgage with recourse is treated as a sale by the property owner notwithstanding the involuntary nature of the transaction. *Helvering v. Hammel*, 311 U.S. 504, 510, 61 S.Ct. 368, 371, 85 L.Ed. 303 (1941). The same is true with respect to foreclosure of a mortgage or other lien where the holder of the lien has no recourse against the owner for a deficiency. *Helvering v. Nebraska Bridge Supply & Lumber Co.*, 312 U.S. 666, 61 S.Ct. 827, 85 L.Ed. 1111 (1941). The amount realized for income tax purposes in the sale of property subject to a nonrecourse mortgage equals the balance of the debt, whether the sales price is more or less than the debt or the property's value, and whether it is a sale to a third party or a deed in lieu of foreclosure. *Commissioner v. Tufts*, 461 U.S. 300, 103 S.Ct. 1826, 75 L.Ed. 2d 863 (1983) (assumed nonrecourse mortgage exceeded value of property); *Crane v. Commissioner*, 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947) (property sold for more than nonrecourse debt); *Laport v. Commissioner*, 671 F.2d 1028 (7th Cir. 1982) (deed in lieu of foreclosure). If the mortgage is with recourse, and the transaction involves satisfaction of the entire debt, the amount realized is also the full amount of the debt. *Chilingirian v. Commissioner*, 918 F.2d 1251 (6th Cir. 1990).

3. *Yarbro v. C.I.R.*, 737 F.2d 479 (5th Cir. 1984) involved a nonbankruptcy setting in which the property (raw land) securing a non-recourse debt dropped in value below the face amount of the non-recourse mortgage. The joint venturers who owned the property determined to abandon the property and so notified the mortgagee. The joint venturers declined to transfer the property to the mortgagee. The bank thereafter obtained title to the property through foreclosure. The dispute before the tax court was whether the loss from the abandonment of the joint venture property was ordinary loss or long-term capital loss. The Commissioner took the position that the abandonment of the property was a sale or exchange and resulted in long-term capital loss. The tax court agreed and the Fifth Circuit affirmed. The court said that three elements are necessary for an "exchange": "A giving, a receipt, and a causal connection between the two." In the case of an abandonment of property subject to non-recourse debt, the owner gives up legal title to the property. The mortgagee, who has a legal interest in the property, is the beneficiary of this gift, because the mortgagee's interest is no longer subject to the abandoning owner's rights. *Yarbro* at 483-84. The court held that "one who abandons property subject to non-recourse debt receives a relief from the debt obligation when he gives up legal title." *Yarbro* at 485.

4. *In re McGowan*, 95 B.R. 104 (Bkrtcy, N.D. Iowa 1988): Trustee applied for a ruling from the bankruptcy court determining his liability to the IRS and State of Iowa relative to his abandonment, prior to closing of estate, of farm equipment and machinery. The trustee filed a fiduciary return reporting ordinary gains income from the property abandoned. Court noted that the trustee appeared to be a sideline observer to the dispute inasmuch as there were no assets to pay the taxes, should they be determined to be due by the estate. The court felt the trustee was arguing the case with a view to protecting the post-bankruptcy debtors and not necessarily with a view to the best interests of the bankruptcy estate or the trustee. Court concluded that the abandonment of property of the estate by the trustee was a transfer within the meaning of IRC §1398(f)(2) and was therefore not one which is treated as a disposition for purposes of assigning tax consequences to the trustee. In the opinion of the court, the meaning of "termination of the estate" as used in §1398(f)(2) included termination of the estate's interest in property pursuant to 11 U.S.C. §554(a). In reaching this result, the court distinguished the abandonment in the bankruptcy context from the abandonment by the debtor outside of bankruptcy which was addressed in *Yarbro V. Commissioner*, supra, on the basis that in the case of a

bankruptcy, the trustee does not hold legal title, and the court further had difficulty in finding that the trustee received anything in return for the abandonment as was discussed in *Yarbro*.

The court in *McGowan* stated that:

> This court has difficulty with the notion that the mere act of abandoning burdensome property creates tax liability for the trustee. The effect of such a rule could be to place the burden of any taxes arising from such "dispositions" upon the unencumbered assets which might otherwise be distributed to unsecured creditors.

This writer queries whether the latter statement by the court is consistent with both tax and bankruptcy policy. First, one clear aim of bankruptcy policy is to protect the priority which taxing authorities have to be paid first out of the assets of the debtor's estate before unsecured creditors are allowed to benefit. The tax laws, on the other hand, reflect a policy that a taxpayer not be permitted to remove from his estate, without triggering recognition of deferred tax liability, an encumbered asset with a low basis compared to the amount of debt affecting the property. (See *Hammel*, *Nebraska Bridge Supply*, *Tufts*, *Crane*, *Laport*, and *Chilingirian*, supra). Therefore, it is arguably violative of both bankruptcy and tax policy to allow a bankruptcy trustee to separate this deferred tax liability from the patrimony of the taxpayer which constitutes the bankruptcy estate by abandoning the property without recognition of the gain. Moreover, as the provisions of IRC §1398 represent perhaps exceptions to normal tax rules designed to enhance the debtor's fresh start (i.e. trustee succeeds to debtor's assets with carryover of basis and tax attributes, and debtor escapes liability for tax on gains recognized through the administration of the estate in bankruptcy), it seems that Congress elevated the policy of allowing the debtor a fresh start over the policy preferring the imposition of taxes.

5. In *Samore, Trustee v. Olson, et al*, 100 B.R. 458 (Bkrptcy N.D. Iowa 1989), the same bankruptcy judge from the Northern District of Iowa followed his earlier decision in *McGowan* and ruled again that the abandonment by the trustee was a transfer other than by sale or exchange which is excepted from tax consequences under IRC §1398(f)(2). Thus, the tax liability incurred upon foreclosure was transferred to the debtor. The court here noted that although imposing a large tax bill on a debtor would certainly inhibit the debtor's fresh start, the court must "consider the "fresh start" of a debtor within the confines of the law. The chapter 7 debtor is not given a fresh start from all debts. There are statutory limits to discharge. 11 U.S.C. §§727 and 523." *Samore*, at 464. The District Court affirmed on the ground that the abandonment was not a sale or exchange, an issue dealt with by the bankruptcy court; but the district court chose not to discuss the "termination of the estate" requirement. *In re Olson*, 121 B.R. 346 (N.D. Iowa 1990). The Eighth Circuit affirmed on both issues stating: "Furthermore, the bankruptcy estate does not incur a tax liability when property is abandoned by operation of law at the close of the bankruptcy estate. See IRC §1398(f)(2). We, like the bankruptcy and district courts, can see no reason why abandonment should have a different effect." *In re Olson*, 930 F.2d 6, 8 (8th Cir. 1991).

6. *In re A.J. Lane & Co., Inc.*, 133 B.R. 264 (Bkrptcy. D. Mass. 1991) a chapter 11 trustee requested authority to abandon a mortgaged apartment complex to the debtor in order to shift foreclosure tax consequences from the estate to the debtor. The debtor objected to the abandonment on the basis that the statutory requisites for abandonment were not present and that the abandonment would shift the tax liability to the debtor and destroy the debtor's opportunity for a fresh start. The court held that the trustee's proposed abandonment of the mortgaged property to the debtor prior to a scheduled foreclosure sale and prior to closing the case, would be a taxable sale, taxable to the bankruptcy estate rather than the debtor. The court noted that in findings to the contrary, the *McGowan* and *Olson* decisions failed to recognize that the estate received a benefit in the discharge of the secured portion of the debt, and thus the requirement under *Yarbro* of a benefit in connection with abandonment was satisfied.

The court in *A.J. Lane* placed great weight on the Supreme Court decision in *Commissioner v. Court Holding Co.*, 324 U.S. 331, 65 S.Ct. 707, 89 L.Ed. 981 (1945). In this case a corporate taxpayer negotiated an oral agreement to sell an apartment building, its sole asset, and received a deposit from the seller. Upon learning

that the sale would trigger a large corporate tax liability, the corporation conveyed the property to its two stockholders who in turn conveyed it to the purchaser under the terms of the agreement originally negotiated by the corporation. In holding the transaction taxable to the corporation, the same as though it had made the sale, the court stated:

> The incidence of taxation depends upon the substance of the transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, **which exist solely to alter tax liabilities**, would seriously impair the effective administration of the tax policies of Congress (emphasis supplied).

324 U.S. 331, 334, 65 S.Ct. 707, 708, 89 L.Ed. 981. The court in *A.J. Lane* found the situations analogous:

> The Trustee seeks to accomplish here what was attempted in Court Holding--to transfer property already the subject of a sales transaction to another party for the purpose of having the other taxed on the sale. Here, a foreclosure sale rather than a negotiated sale was pending, but there is no difference in substance. As in *Court Holding*, the purchaser and the terms of the sale remained unchanged.

The court found that the plain meaning of the provisions of §1398(f)(2), when it says: "In the case of a termination of the estate", is that it applies only to a transfer from the estate to the debtor at the termination of the estate. Thus, on the court's findings that: (i) abandonment would result in gain recognition to the estate because the abandonment would be prior to termination of the estate, and to find otherwise would be violative of the *Court Holding* decision; (ii) even should the abandonment make the debtor taxable on the foreclosure sale, that tax burden would inhibit the debtor's fresh start; and (iii) §554 should be interpreted in a fashion which promotes the debtor's fresh start in the absence of countervailing considerations which override the fresh start policy, the trustee's application for approval of the abandonment was denied.

7. *In re Rubin*, 154 B.R. 897 (Bkrptcy, D. Maryland 1992), dealt with a motion by a creditor to compel the chapter 11 debtor to abandon a partnership interest prior to consummation of a settlement which involved a deed in lieu of foreclosure with respect to property owned by the partnership, the purpose of the abandonment being to save the estate from a $300,000 tax liability which would occur upon closing of the settlement. The debtors opposed the motion and the court denied the motion, adopting the reasoning of *A.J. Lane & Co.* The court stated that:

> Whatever the rule in the Eighth Circuit [referring to the Olson decision], it is unlikely that the Fourth Circuit would approve this court's revision of §1398(f)(2) to comply with the Bank's desires. "[T]he fact that Congress might have acted with greater clarity or foresight does not give courts a carte blanche to redraft statutes in an effort to achieve that which Congress is perceived to have failed to do." *U.S. v. Locke*, 471 U.S. 84, 95, 105 S.Ct. 1785, 85 L.Ed.2d 64 (1985).

8. *In re Laymon*, 1989 WL 252447 (D. Minn. July 25, 1989) a Chapter 7 trustee's desire to abandon property prior to foreclosure was tax-driven also. The trustee sought to shift a $17,000 tax liability to the debtor. Noting that the estate had benefitted by holding the property for two years by collecting $22,000 in rental income, the court refused to allow the proposed abandonment.

9. The IRS has issued a private letter ruling which concedes that abandonment during the case has no tax consequences to the estate, on the ground that "termination of the estate" as it appears in IRC §1398(f)(2) includes termination of the estate's interest in the property by virtue of abandonment or exemption. *PLR 90-17075* (January 31, 1990). In both the *McGowan* and *Olson* cases, the IRS took the position that the estate was not taxable upon an abandonment during the administration of the estate.

10. It is therefore clear that the IRS will take the position that a tax liability of the estate is not triggered upon such an abandonment. It will, no doubt, take the position that if such an abandonment occurs, a subsequent foreclosure or dation of the property will trigger a post-petition tax liability of the debtor. The case law is in no way settled on this issue, unless you are in the Eighth Circuit. Competent bankruptcy counsel should therefore be prepared to fight tooth and nail to oppose efforts by the trustee to abandon property under these circumstances. If these efforts fail, then the debtor will then have to make a decision as to how to report the transaction when the foreclosure does occur. If the holdings of *A.J. Lane*, *In re Rubin*, and *In re Laymon*, are correct, then the tax should be imposed upon the estate. If indeed these decisions are correct, then to the debtor the foreclosure sale transaction could be reported as a sale but with a tax basis equal to the amount of debt on the property at the time it was abandoned to the debtor inasmuch as the purchase price of property includes debt assumed, or to which the property is subject at the time of the purchase.

G. Special Tax Rules Relative To State Income Taxes.

1. Section 346 of the Bankruptcy Code contains special rules similar to those contained in IRC §1398 and makes such rules applicable for purposes of state income taxes. The provisions of §346 apply notwithstanding any state or local tax law, subject to the Internal Revenue Code. Section 346 was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and former Section 728 was repealed, with most of its provisions being relocated in §346. Former provisions of Sections 1146(a) and (b) were also moved to §346. The changes largely conform the approach in §346 to state and local taxes to the approach taken in IRC §1398.

2. In a case concerning an individual under Chapter 7 or 11 where a separate taxable estate or entity is created under the Internal Revenue Code, income of the estate is taxable only to the estate and not to the debtor, unless the case is dismissed.[1] If such individual is a partner, or member in an LLC treated as a partnership, the tax attributes of the partnership or LLC are distributable to the partner's estate rather than to the partner[2]. Except as otherwise provided in §346, the estate of an individual in Chapter 7 and Chapter 11 cases is to be taxed as an estate[3]. The estate shall use the accounting method the debtor used immediately before the commencement of the case, if the accounting method complies with applicable bankruptcy law[4], but need not use the same accounting period[5].

3. The estate of a partnership, LLC, or a corporate debtor, is not a separate entity for tax purposes.[6] Income of said debtor is to be taxed as if the case were not commenced, except as otherwise provided in §346. The estate is liable for any taxes imposed on the partnership, LLC, or corporate debtor, but not the tax imposed on the individual partners or members[7]. The trustee must file all State and local tax returns on behalf of the partnership or corporation during the case. §346(b).

4. The estate in a Chapter 13 case is not a separate taxable entity and all income of the estate is to be taxed to the debtor. §1398(a), §346(b).

5. Section 346(h) requires the trustee to comply with any Federal, State, or local tax law requiring withholding or collection of taxes from any payment of wages, salaries, commissions, dividends, interest, or other payments. Any amount withheld is to be paid to the appropriate governmental unit at the time and in the manner required by the tax law requiring the withholding, with the same priority as the claim from which such amount withheld was paid.

6. Except to the extent that a transfer of property is treated as a disposition under the Internal Revenue Code [i.e. by virtue of §1398], for purposes of any State or Local tax law, the transfer of property from the debtor to the estate, or from the estate to the debtor, will not be treated as a disposition for purposes of assigning tax consequences. §346(f)

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[1] §346(a)
[2] §346(a), (c)
[3] §346(g)
[4] §346(e)
[5] §346(d)
[6] §1399
[7] §346(b)

7. The creation of the estate of an individual under Chapter 7 or 11 as a separate taxable entity does not affect the number of taxable years for purposes of computing loss carryovers or carrybacks. §346(h).

8. When an individual files under Chapter 7, 11, or 12, the estate shall succeed to the individual debtor's tax attributes. Attributes not used by the estate will return to the debtor, who may use such attributes as though the case had not been commenced. The estate may carryback losses of the state to a taxable period of the debtor that ended before the case was filed. The debtor may not carryback any loss of his own from a tax year during the pendency of the case to such a period until the case is closed.

9. Section 346(j) declares rules for determining the state or local law tax effects of forgiveness or discharge of indebtedness. As a general rule, discharge or forgiveness of debt will not be taxable except to the extent it is taxable under the Internal Revenue Code of 1986. Section 346(j)(2) provides that whenever the IRC provides for exclusion of income from discharge of indebtedness and a reduction to the Debtor's tax attributes on account thereof, a similar reductoni shall be made under any State of local law imposing a tax on or measured by income, to the extent such law recognizes such attributes.