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TAXATION ISSUES THAT IMPACT BANKRUPTCY CASES

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I. INTRODUCTION

"Taxes," as Justice Holmes informed us long ago, "are what we pay for civilized society."[1] It may surprise many that this price is extracted even from individuals in bankruptcy. Although the right to discharge in bankruptcy ensures an "honest but unfortunate debtor" a fresh start to begin anew his or her economic life, that right is tempered by the federal government's legitimate interest in protecting the public coffers by collecting taxes. The balance that the Bankruptcy Code[2] and Internal Revenue Code[3] strike between the competing interests of an individual debtor and the federal government insulates specific tax claims from the bankruptcy discharge. Under this compromise, only enumerated tax claims will survive a bankruptcy discharge in a chapter 11 case.[4]

Recognizing that nondischargeable tax liabilities are inconsistent with the fresh start policy, Congress further attempted to alleviate some harshness through enactment of the Bankruptcy Tax Act of 1980 (BTA).[5] Among other things, the BTA creates a separate taxable entity where an individual files for relief under either chapter 7 or 11 of the Bankruptcy Code[6] and enables an individual chapter 7 or 11 debtor to elect to shorten and end the taxable year, thus shifting at least part of the current year taxes to the estate as a BC § 507(a)(8) priority claim.[7] Nevertheless, certain tax claims designated as nondischargeable under BC § 523(a)(1) (such as

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[1] *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927)(dissenting opinion).

[2] 11 U.S.C. § 101 et seq. In these materials, the Bankruptcy Code is also referred to as "BC."

[3] Title 26, United States Code. In these materials, the Internal Revenue Code is also referred to as "IRC."

[4] 11 U.S.C. § 523(a)(1)(identifying those tax claims that are nondischargeable by an individual debtor in a chapter 7 or 11 case).

[5] Pub. L. No. 96-589, 94 Stat. 3389 (1980)(codified at several sections of the IRC).

[6] See IRC § 1398. No separate entity for tax purposes is created where a partnership or corporation files for bankruptcy relief. IRC § 1399.

[7] See IRC § 1398(d)(2).

claims for taxes incurred within three years of the bankruptcy petition date) survive the discharge and, thus, significantly affect a debtor's fresh start.

The outline begins with a discussion of the rules regarding the treatment of cancellation of indebtedness (COD) income in bankruptcy and the tax issues that arise from foreclosure sales or short-sales under Internal Revenue Code (IRC) section 108. Next, the article focuses on the separate entity rules under IRC section 1398. Section 1398 creates much of the confusion; therefore, a thorough understanding of that section is necessary to understand better what is at stake in the abandonment context. Finally, the outline explores the issues of the priority and dischargeability of tax claims, carefully distinguishing between the tax relief a debtor could expect in a chapter 7 or 11 case as opposed to a chapter 13 case. Of particular note is that the chapter 13 super-discharge will no longer work to discharge certain tax claims beyond the discharge one would expect in a chapter 7 case as in the past. Rather, once the 2005 Act went into effect, the chapter 13 discharge generally mirrors the chapter 7 discharge for tax purposes.

As promised, the materials will introduce the reader to five rules that every bankruptcy practitioner must know. These five rules are:

1. Cancellation if indebtedness (COD) is not recognized as income if the taxpayer is a debtor in bankruptcy. However, certain tax attributes must be reduced in order to absorb what otherwise would have been COD income.[8]
2. A real property foreclosure or "short-sale" generally generates both COD income and gain (or loss).[9]
3. An individual who files for relief under chapter 7 or 11 creates a separate taxable entity, that is, his or her bankruptcy estate.[10]
4. Most individuals should elect to bifurcate their tax year to take advantage of the special bankruptcy tax rules in the Internal Revenue Code.[11]

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[8] *See* IRC §108.
[9] *See* IRC §§108, 1001.
[10] *See* IRC §1398.
[11] *See* IRC §1398(d).

5. Not all taxes are nondischargeable.[12] Nondischargeable taxes require an attorney to ask several questions:

   a. Looking back from the petition date, what returns were last due (including extensions) within the last three years? Personal taxes are dischargeable if the tax year in question is more than three years prior to the filing of the bankruptcy case.

   b. Have any taxes been assessed within 240 days preceding the petition date? Personal taxes are dischargeable if the tax in question has been assessed more than 240 days prior to the filing of the bankruptcy case.

   c. Are any returns still under audit or at audit risk (not including those that involve fraudulent returns, etc.)?

   d. Are there any late filed returns or years in which no return was filed? Personal taxes are dischargeable if the tax return for the year in question was filed at least more than two years prior to the bankruptcy filing.

   e. Are there any taxes that arise from the filing of fraudulent returns or willful attempts to evade or defeat a tax?

II. COD SCENARIOS

Federal tax issues often arise in the course of contemplating a variety of responses to too much debt. For example, the release of credit card debt by a credit card company, the write down of indebtedness often to the fair market value of any collateral like a home mortgage, and the transfer of property in complete or partial satisfaction of the indebtedness are all potential triggering tax events that may generate cancellation of indebtedness ("COD") income or gain (or loss). In fact, under federal law, a creditor is required to file a Form 1099C whenever it forgives or cancels a loan balance greater than $600. The taxpayer must account for the amount of COD, any attribute reduction, and any recognized income on Form 982, attached to his tax return. Following are three common scenarios.

[12] *See* IRC §523(a).

A. RELEASE OF DEBT

Example 1: ***Release:*** Taxpayer can no longer pay his credit card debt. Credit Card Company agrees to release $500 of debt for payment of $100. Taxpayer must recognize $400 as COD income.

B. WRITE DOWN OF RECOURSE AND NONRECOURSE INDEBTEDNESS

Example 2: ***COD Income Generated By Write-Down of Debt (Recourse or Nonrecourse):*** Taxpayer borrows $500 from Lender, agreeing to pay Lender $500 in one year. To secure repayment of the indebtedness, Taxpayer grants a security interest in property valued at $500. When the indebtedness becomes due, Lender agrees to write down the debt to $400, the present fair value of the collateral. Taxpayer would realize $100 of COD income.[13]

C. TRANSFER OF PROPERTY IN SATISFACTION OF INDEBTEDNESS

Example 3: ***Property in Satisfaction of Indebtedness***: Taxpayer owes Lender $500, secured by an office building valued at $300. The debt is recourse. If Taxpayer transfers the property to Lender through a deed in lieu or a foreclosure in exchange for complete forgiveness of the indebtedness, Taxpayer will realize $200 in COD income. (COD Income = Indebtedness - Fair Market Value of Collateral).

With these potential tax events in mind, we begin our discussion of the tax ramifications of discharge of indebtedness in bankruptcy. Special care and attention will be given to how these tax rules apply in the context of individual debtor bankruptcy cases.

III. CANCELLATION OF INDEBTEDNESS INCOME METHODOLOGY

Some of the most difficult issues in the law are posed by the restructuring of indebtedness coupled with the filing of a bankruptcy petition. Beyond the traditional state and bankruptcy law implications, difficult tax issues regularly challenge even the expert in the field. As an aid to identifying and addressing the potential tax issues, I suggest a methodology that should be helpful in most situations.

[13] See Rev. Rul. 91-31.

The methodology I suggest rests on four related but distinct levels or orders of inquiry. Tax issues can be quite complex. By adhering to a sophisticated but simple plan of attack, one can quickly zero in on the actual issues posed by the restructuring and the range of solutions available.

The ***first order*** inquiries involve the following:

1. ***Has an event taken place that could potentially give rise to COD income or gain?*** Here, one would determine whether there has been a write down of indebtedness, partial or complete forgiveness of debt, a material modification of the indebtedness, a direct or indirect acquisition of debt by a related party, a transfer of property in satisfaction of debt, or some other sale or exchange.

2. ***Is there either a case law or statutory rule of nonrealization that may apply?*** Here, the case law and statutory rules of exception include the gifts exception, the indebtedness subject to bona fide dispute exception, lost deduction exception, purchase price adjustment exception, contribution of capital exception, stock-for-debt exception, and partnership equity-for-debt exception.

3. ***When, if at all, must the COD income or gain be realized?*** Here, the rules on when COD income occurs are muddled. Under state law, one should generally look to some objective act that evidences a partial or complete discharge, material modification, etc., of indebtedness. If the discharge allegedly occurs in bankruptcy, one must isolate a bankruptcy court order discharging the indebtedness.

The ***second order*** inquiries include:

> ***Assuming a taxpayer must realize COD income, is there a rule of nonrecognition that may apply?*** The rules of nonrecognition embodied in IRC §108 that are generally relevant to restructurings include the (i) bankruptcy exception; (ii) insolvency exception; (iii) qualified farm indebtedness exception; (iv) qualified real property indebtedness exception; and (v) home mortgage forgiveness during the January 1, 2007, to January 1, 2013 time frame.

The ***third order*** inquiries include:

> ***Assuming one of the rules of nonrecognition applies, should you reduce tax attributes as identified in section 108(b) or elect to reduce basis in depreciable assets or employ a strategy that uses a combination of the two approaches?*** Here, one must decide whether a taxpayer receives a greater benefit by electing to reduce basis in depreciable property or by simply reducing tax attributes in accordance with IRC §108(b), or embrace an approach that uses a combination of the two alternatives in an effort to minimize potential tax liabilities while preserving tax attributes.

The ***fourth order*** inquiries include:

1. ***Has the filing of a petition in bankruptcy changed the taxpayer, that is, changed who is liable for the tax?*** Here, one must determine whether the separate entity rules under IRC §1398 apply. If so, the bankruptcy estate is a separate taxpayer, with the duty to report, account for, and pay any tax due.

2. ***Assuming that IRC §1398 does apply, should you make the section 1398(d)(2) election?*** The election allows a debtor to bifurcate the tax year, often to the benefit of a debtor by converting what would otherwise be a nondischargeable postpetition obligation into a prepetition priority claim against the estate.

IV. OVERVIEW OF CANCELLATION OF INDEBTEDNESS INCOME

The savings realized by a taxpayer from the material modification, reduction or total discharge of a bona fide debt may be income for tax purposes.[14] The Supreme Court established this principle in *United States v. Kirby Lumber Co.*[15] In Kirby, the corporate taxpayer purchased its own bonds at a discount on the open market. The Court held that the taxpayer realized income to the extent the issue price for the bonds exceeded the price paid for the reacquisition of

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[14] See United States v. Kirby Lumber Co., 284 U.S. 1, 2-3 (1931) (finding gross income where taxpayer bought back some of its own bonds at lower price than that at which bonds were issued). For a more detailed discussion of the treatment of COD income, see Paul H. Asofsky, *Discharge Indebtedness Income in Bankruptcy After the Bankruptcy Tax Act of 1980,* 27 ST. LOUIS U. L.J. 583 (1983); Boris I. Bittker & Barton H. Thompson, Jr., *Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber* Co., 66 CAL. L. REV. 1159 (1978); Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness,* 10 VA. TAX. REV. 1 (1990).

[15] 284 U.S. 1 (1931).

those bonds.[16] Section 61(a)(12) of the IRC provides that gross income includes "income from the discharge of indebtedness.[17] While neither the IRC nor Treasury regulations provide any further definition of what constitutes COD income, case law has provided that COD income may result from complete or partial forgiveness of indebtedness,[18] the modification of the terms of indebtedness,[19] or the foreclosure of property subject to recourse debt.[20] Generally, upon discharge of indebtedness, a taxpayer realizes income in an amount equal to the difference between the amount due on the obligation and the amount paid for the obligation's discharge.[21]

> **Example 4:** Debtor borrows $500 from Lender, to be repaid one year from the loan. Lender subsequently cancels the debt after unsuccessfully attempting to recover. The original transaction would have no tax significance since the loan benefits to Debtor would be offset by the obligation to repay. If the obligation is removed, Debtor theoretically benefits from the "freeing up" of assets. This "benefit" is taxable. A more elegant way in which to view the situation is through the lens of the tax benefit rule.[22] In Year 1, the loan had no tax significance because the accession in wealth was tempered by a corresponding liability. Thus, the transaction is a "tax wash." However, in Year 1+X, an event takes place that makes the manner in which you treated the original transaction in Year 1 no longer valid. The event, of course, is the forgiveness of the indebtedness. Thus, the tax benefit rule requires that the taxpayer make the necessary adjustments in Year 1+X to reflect the realities of the present situation.

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[16] Id. at 3. The Court explained:

As a result of its dealings [the taxpayer] made available $137,531.30 [in] assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The... [taxpayer] has realized within the year an accession to income, if we take the words in their plain popular meaning, as they should be taken here.

[17] IRC § 61(a)(12).

[18] See Commissioner v. Jacobson, 336 U.S. 28, 38-40 & n.7 (1949) (holding repurchase of secured bonds at prices below that at which they were sold generated gain attributable to taxpayer's income).

[19] See Stackhouse v. United States, 441 F.2d 465, 469 (5th Cir. 1971) (stating modification of partnership's debt is considered a pro rata distribution of money to each partner, creating income to partners individually). But see IRC § 108(e)(5). Under §108(e)(5), the modification of a purchase-money debt will not produce income where the reduction does not occur in a title 11 case or when the taxpayer is insolvent. Id.

[20] Rev. Rul. 90-16, 1990-1 C.B. 12, 13.

[21] Different rules apply where obligations have been issued at a discount. See IRC §108(e)(3); see also William Tatlock, *Discharge of Indebtedness, Bankruptcy and Insolvency,* Tax Mgmt. (BNA) No. 466-2d, at A-9 (May 17, 1993).

[22] See Alice Cunningham, *Payment of Debt with Property--The Two Step Analysis After Commissioner v. Tufts*, 38 TAX LAW. 575, 599-605 (1985)

Before enactment of the Bankruptcy Tax Act of 1980[23] ("BTA"), the general rule was that debt discharge resulted in the realization of income to the extent of the amount discharged.[24] However, exceptions to this general rule evolved through case law, including the (1) gift exception, (2) bona fide debt exception, (3) stock-for-debt exception,[25] (4) contribution of capital exception,[26] and (4) purchase price adjustment exception.[27] Furthermore, debt forgiven in a bankruptcy proceeding and debtors who were insolvent both before and after the debt forgiveness also qualified for a limited exception to the general rule requiring the realization of COD income.[28] Finally, corporations and certain non-corporate taxpayers, to the extent solvent after debt forgiveness, could avoid income recognition by making an election under IRC section 108 and consenting to a reduction of basis in assets, depreciable and non-depreciable, under IRC section 1017.[29]

A number of problems existed under prior law regarding treatment of COD income. For instance, a debtor who elected to avoid recognizing COD income by reducing basis in property under IRC section 1017, could effectively convert what otherwise would have been ordinary income into capital gain upon selling those assets with a reduced basis. In some instances, certain nondepreciable assets, such as land or stock of a subsidiary corporation, might never be sold in

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[23] Pub. L. No. 96-589, 94 Stat. 3389.

[24] See IRC § 61(a)(12). An in-depth treatment of the prior law governing discharge of indebtedness appears in C. RICHARD MCQUEEN & JACK F. WILLIAMS, FEDERAL TAX CONSEQUENCES OF BANKRUPTCY LAW AND PRACTICE §23.01 (3d ed. 1997).

[25] McQUEEN & WILLIAMS, § 21.16.

[26] Id. § 21.15.

[27] Id. § 21.14.

[28] Treas. Reg. § 1.61-12(b)(1) (as amended in 1980). See Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95, 96 (5th Cir. 1934) (finding no income where cancellation of past due debt does not have effect of increasing asset's value); F.W. Sickles Co. v. United States, 31 F. Supp. 654, 656 (Ct. Cl. 1940) (noting insolvent taxpayer has no income generated from discharge of indebtedness).

[29] See McQUEEN & WILLIAMS, § 23.11.

the normal course of business. This resulted in the total avoidance of a tax liability, rather than mere deferral of the tax.[30]

A. CANCELLATION OF INDEBTEDNESS INCOME UNDER SECTION 108

Under IRC section 108, a taxpayer's gross income shall not include amounts realized from the discharge of indebtedness when:

(1) the discharge occurs in a title 11 case;[31]

(2) the debtor is insolvent immediately before the discharge;[32]

(3) the indebtedness is considered "qualified farm indebtedness;"[33]

(4) the indebtedness is considered "qualified real property indebtedness; or[34]

(5) the indebtedness is considered qualified home mortgage indebtedness and the forgiveness takes place during the January 1, 2007, to January 1, 2013 time frame.[35]

Furthermore, title 11 debtors and insolvent taxpayers are given a choice of tax consequences to provide broader flexibility and a more robust fresh start. In accordance with IRC § 108 and 1017, taxpayers may apply the amount of COD income against certain statutorily delineated tax attributes, such as net operating losses and carryovers,[36] or elect to apply any

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[30] H.R. REP. No. 833, 96th Cong., 2d Sess. 9 (1980); S. REP. NO. 1035, 96th Cong., 2d Sess. 9-10 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7025 (noting possibility that taxpayer might take reduction in basis in property which would never be sold).

[31] IRC §108(a)(1)(A). Thus, it is imperative that any COD occur pursuant to a court order or confirmed plan. Michael G. Frankel, *Tax Planning for Troubled Real Estate and Partnership Transactions-Part I,* 19 J. REAL EST. TAX'N 285, 290 (1992). The BTA defines a title 11 case as a federal bankruptcy case brought under title 11. See IRC §108(d)(2). In addition, the taxpayer must be under the court's jurisdiction, and the discharge must be either granted by the court or pursuant to a court-approved plan. Id.

[32] IRC § 108(a)(l)(B). The Bankruptcy Tax Act of 1980 states that other than those exceptions specifically provided in IRC § 108(e), there is no other insolvency exception to the rule that gross income includes debt discharge income. Id. § 108(e)(1).

[33] Id. § 108(a)(1) (C).

[34] Id. § 108(a)(1)(D). The insolvency exclusion takes precedence over the qualified farm or real property indebtedness exclusions, and the title 11 bankruptcy exclusion takes precedence over all three. § 108(a)(2).

[35] Id. § 108(a)(1)(E).

[36] Id.§ 108(b). Provision is made for the potential reduction of certain tax attributes and the order in which they may be reduced is set out. Id. § 108(b)(2)(A)-(G).

portion of COD to reduce the basis of "depreciable property" or a combination of both.[37] This choice allows taxpayers the flexibility of accounting for COD income in a manner most favorable to their own tax positions.[38]

B. CANCELLATION OF INDEBTEDNESS INCOME ISSUES UNRESOLVED BY IRC SECTION 108

Although IRC § 108 defines some of its operative terms, several omissions are noteworthy and deserve reconsideration. Interestingly, several of the more important practical issues are not addressed by the BTA.

1. Has an event triggering cancellation of indebtedness income occurred?

Section 108 fails to provide a working definition of the term *discharge of indebtedness*. Consequently, courts will continue to bear the responsibility of developing a definition through the interstitial growth of case law.[39] The American Bar Association Section of Taxation has proposed a good working model of discharge of indebtedness. In the Report of the Section 108 Real Estate and Partnership Task Force,[40] the Section suggests as a starting point the following two-part test: (1) whether at the inception of the loan transaction, the borrowed funds were excluded from the taxpayer's income upon receipt because of the offsetting obligation to repay;

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[37] Id. § 108(b)(5).

[38] For example, it would be advantageous for a taxpayer to reduce net operating losses where it believes that they will end up being "wasted" due to lack of income. S REP. NO. 1035, reprinted in 1980 U.S.C.C.A.N. at 7025. However, where a taxpayer expects to have income which could be offset by net operating losses, the taxpayer may also reduce basis in property. Id.

[39] See United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931) (repurchase of corporate bonds by corporation for less than par value constitutes discharge of indebtedness); Commissioner v. Sherman, 135 F.2d 68, 70 (6th Cir. 1948) (no gain in income where mortgage bank accepted partial payment and where effect of transaction was a reduction in purchase price of property); Colonial Savings Ass'n. v. Commissioner, 85 T.C. 855, 861 (1985), *cert. denied*, 489 U.S. 1090 (1989) (penalties for premature withdrawal of savings certificates do not give rise to income from discharge of indebtedness); Edmont Hotel Co. v. Commissioner, 10 T.C. 260, 263 (1948) (taxable income realized in acquiring own bonds at less than face value).

[40] American Bar Association Section of *Taxation, Report of the Section 108 Real Estate and Partnership Task Force, Part 1*, 46 TAX LAW. 209 (1992) [hereinafter *ABA Report Part I*]; American Bar Association Section of Taxation, *Report of the Section 108 Real Estate and Partnership Task Force, Part II,* 46 TAX LAW. 397 (1993) [hereinafter *ABA Report Part II*].

and (2) if so, whether the taxpayer's obligation to repay has been canceled, forgiven or reduced.[41] Nonetheless, a taxpayer might argue that section 108 is not applicable, by citing a judicial exception to the general rule of COD income. For example, under prior case law no COD income was realized when the cancellation of a debt was intended as a gift[42] or the cancellation was of a disputed debt.[43] The failure of IRC § 108 to provide a precise definition of *discharge of indebtedness* should not affect this conclusion.

The IRC describes *indebtedness of the taxpayer as* inclusive of two distinct types of indebtedness: (1) debts for which a taxpayer is personally liable; and (2) debts on property owned by a taxpayer, such as a mortgage on real estate owned by the taxpayer.[44] Thus, discharges of both recourse and nonrecourse debts of a taxpayer are subject to section 108.[45]

> **Example 5:** Taxpayer owes a $1.5 million recourse debt, secured by an office complex valued at $1.0 million. If Lender agrees to write down the debt as part of a restructuring to the value of the collateral, Taxpayer will realize COD income of $500,000.
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> **Example 6:** Same facts as above except that the indebtedness is nonrecourse. Taxpayer will realize COD income of $500,000.[46]

2. When was the cancellation of indebtedness income realized?

Section 108 does not address the issue of *when* COD income is realized. The precise answer turns on whether the COD occurs in or out of bankruptcy. Outside of bankruptcy, the ABA Tax Section has suggested the following test:

> As a general rule, a debt is discharged upon the earlier to occur of: (1) forgiveness by agreement of the parties; (2) cancellation by a binding act of the creditor or by

[41] *ABA Report Part I* at 224.
[42] Tatlock, at A-14.
[43] McQUEEN & WILLIAMS, § 20.18.
[44] IRC §108(d)(1).
[45] See Rev. Rul. 91-31, 1991-1 C.B. 19. "The reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt ... results in the realization of discharge of indebtedness income ..." Id. at 20. See generally Tatlock A-13 to A-14.
[46] See Rev. Rul. 91-31.

> operation of applicable law (such as in certain cases the running of the statute of limitations); or (3) a creditor's acceptance of payment of an amount less than the issue price of the debt (less any principal amounts previously repaid) in complete satisfaction thereof.[47]

In bankruptcy, the timing of the event of discharge is even more muddled. The ABA would tie discharge of indebtedness to bankruptcy discharge under sections 727, 1141(d) or 1328.[48] However, where a creditor "enters into a binding agreement (generally pursuant to court order)" to forgive all or part of a debt before the discharge event, then COD income is realized at that point.[49] This is a sensible approach. Assuming the debt is dischargeable, the entry of a discharge order is the latest possible moment for the realization of COD income. Likewise, because of the requirement that a compromise or settlement involving the debtor or estate must be approved,[50] the court order approving the settlement is also a sensible point for realizing COD income. Since no discharge results from Chapter 7 cases involving partnerships or corporations or liquidations under Chapter 11, similar indicators, such as a final settlement of the affairs of the debtor entity should be used to determine when COD income occurs in such cases.[51]

C. BANKRUPTCY EXCEPTION TO THE RECOGNITION OF CANCELLATION OF INDEBTEDNESS INCOME

As previously discussed, a taxpayer need not recognize COD income if the discharge of debt occurs in a title 11 case.[52] Specifically, a taxpayer must be under the bankruptcy jurisdiction of a court at the time the COD occurs. Additionally, the debt discharge must occur

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[47] ABA *Report Part I* at 228.
[48] Id.
[49] Id. at 228-29.
[50] BANKR. R. 9019.
[51] See generally, Tatlock at A-12(1) to (2) (noting that COD income is realized when it is clear that debt will not be paid).
[52] IRC § 108(a)(1)(A).

pursuant to court order or a plan approved by the court.[53] Thus, it is important to ensure that a bankruptcy court order or a confirmation order approving a plan of reorganization specifically reference the discharge of indebtedness.[54]

Assuming the bankruptcy exception in IRC §108(a)(1)(A) applies, the method of deferment is similar to that for the insolvency exception. A taxpayer must (1) reduce tax attributes in the order delineated in 108(b), (2) elect to reduce basis in depreciable property pursuant to section 108(b)(5), or (3) employ a combination of the two approaches. However, unlike the insolvency exception, the bankruptcy exception is not limited to the extent a taxpayer is insolvent. Thus, close calls on insolvency generally lead one to seek the relative comfort of certainty that bankruptcy provides for taxpayers with large amounts of potential COD income.

In sum, Title 11 debtors and insolvent taxpayers are given a choice of tax consequences to provide broader flexibility and a more robust fresh start. In accordance with IRC sections 108 and 1017, taxpayers may apply the amount of COD income against certain statutorily delineated tax attributes, such as net operating losses and carryovers,[55] or elect to apply any portion of COD to reduce the basis of "depreciable property" or a combination of both.[56] This choice allows debtors the flexibility of accounting for COD income in a manner most favorable to their own tax positions.[57] However, to prevent the conversion of ordinary income associated with COD income into capital gain through an election to reduce basis, the BTA also provides that gains

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[53] IRC § 108(d)(2).

[54] See Stern at A-8(1).

[55] Id. § 108(b). Provision is made for the potential reduction of six tax attributes and the order in which they may be reduced is set out. Id. § 108(b)(2)(A)-(G).

[56] Id. § 108(b)(5).

[57] H.R. REP. No. 833 at 8-9; S. REP. No. 1035, at 9-10, *reprinted in* 1980 U.S.C.C.A.N. at 7025. For example, it would be advantageous for a taxpayer to reduce net operating losses where he believes that they will end up being "wasted" due to lack of income. S REP. NO. 1035 10, reprinted in 1980 U.S.C.C.A.N. at 7025. However, where a taxpayer expects to have income which could be offset by net operating losses, the taxpayer may also reduce basis in property. Id.

realized from the sale of assets with a reduced basis are subject to recapture of the amount of COD income as ordinary income and not as a capital gain.[58]

> **Example 7:** Debtor has total debts of $300,000 and total assets with a fair market value of $275,000. Lender cancels a $100,000 debt. Assuming the debt discharge occurs pursuant to a bankruptcy court order after Debtor had filed its petition in bankruptcy, the entire $100,000 of COD income is deferred and need not be recognized upon discharge. Of course, Debtor may have to reduce certain tax attributes in accordance with IRC § 108(b). Any excess COD income remaining after attributes are reduced is forever excluded from income.

D. INSOLVENCY EXCEPTION TO RECOGNITION OF CANCELLATION OF INDEBTEDNESS INCOME

As previously discussed, a taxpayer need not recognize COD income to the extent the taxpayer is insolvent immediately before the discharge. However, another significant omission in section 108 is its failure to provide a meaningful definition of *insolvency*. Section 108 provides that a taxpayer is insolvent to the extent that its liabilities exceed the "fair market value" of its assets immediately before the debt discharge.[59] The IRC does not define "fair market value."[60] The IRC's traditional definition is the price at which property exchanges hands between a willing seller and a willing buyer, neither under a compulsion to act.[61] One commentator suggests that transaction costs associated with the disposition of the assets should be netted out before the calculation is made.[62] Although this approach is sensible, section 108 does not appear to support it.

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[58] IRC § 1017(d)(l). Subsequent dispositions of property whose basis has been reduced under § 1017 will give rise to income at ordinary rates under §§ 1245, 1250. Id.

[59] IRC §108(d)(3).

[60] Under Bankruptcy Code § 101(31), the valuation standard is "a fair value" and not "a fair market value."

[61] Treas. Reg. § 1.70A-1(c)(2) (as amended in 1990) (concerning charitable contributions); Id. § 20.2031-1(b) (as amended in 1965) (discussing valuation of property in grog testamentary estates); Id. § 25.2512-1 (as amended in 1992) (regarding valuation of property).

[62] Robert C. Livsey, *Determining if a Taxpayer is Insolvent for Purposes of the COD Income Exclusion,* 76 J. TAX'N 224, 224 (1992).

Additionally, section 108 fails to consider whether exempt assets should be included in the determination of insolvency.[63] Although opposed at one point, the IRS accepted this position on the exclusion of exempt assets, but has recently recanted.[64] The present IRS position is that exempt assets are included in the insolvency calculation.[65] However, persuasive authority does exist for the exclusion of assets that are not subject to the claims of creditors under local law.[66] These authorities state the better view. From a creditor's perspective, insolvency should generally be calculated by reference to those assets that are ultimately available to a taxpayer's general creditors under state law to reduce their debts.[67]

The determination of a taxpayer's insolvency is made "on the basis of the taxpayer's assets and liabilities immediately before the discharge."[68] Thus, where agreement is reached as to the terms of settlement of the claims, the date of actual settlement and not the date of the agreement is used for the insolvency determination.[69] Precisely when this event occurs is not always self-evident.

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[63] Prior to enactment of the BTA, cases held that exempt assets were not counted for insolvency purposes. See, e.g., Cole v. Commissioner, 42 B.T.A. 1110, 1113 (1940) (holding that equity in insurance policies is not included as asset for insolvency determination).

[64] Priv. Ltr. Rul. 91-25-010 (Mar. 19, 1991). The Ruling noted that when considering whether or not a person is insolvent, only assets that are subject to claims of taxpayer's creditors should be used to determine insolvency. Id. "[A] taxpayer's entitlement to the insolvency exclusion... is based on all of the assets reachable by the individual taxpayer's creditors. " Priv. Ltr. Rul. 89-20-019 (Feb. 14, 1989).

[65] TAM 199935002, revoking PLR 9130005.

[66] Id.; see also Davis v. Commissioner, 69 T.C. 814, 833-34 (1978). The court in Cole explained that under New York law the equity in the insurance policies of the taxpayer were free from claims of creditors. 42 B.T.A. at 1113. The court then determined that such exempt property should not be considered when determining insolvency. Id. at 1113.

[67] Gregory Stern poses an intriguing question. If property is excluded from the insolvency calculation, then is it also excluded from basis reduction under §§ 108 and 1017? Stern at A-7. We agree with Stern's answer that exclusion from basis reduction would be consistent with the rules applicable to the bankruptcy exclusion, where the debtor's property protected from sale under the Bankruptcy Code and not included in the bankruptcy estate is not subject to basis reduction. Id. (citing IRC §1017(c)(1)).

[68] IRC § 108(d)(3). Note that the IRS treats preferred stock similar to a liability in making the insolvency computations. Treas. Reg. § 1.1502-19(a)(2)(ii) (as amended in 1991). This author believes that preferred stock should be treated as equity and not as a liability for purposes of these discharge of indebtedness provisions.

[69] Walker v. Commissioner, 88 F.2d 170, 171 (5th Cir.), *cert. denied,* 302 U.S. 692 (1937).

All of these shortcomings under the insolvency exception make the use of section 108 problematic. If one miscalculates the extent of insolvency at the time of debt discharge, there are no second chances. To the extent a taxpayer is solvent, it must recognize COD income and cannot use the tax attribute reduction rules in section 108 unless another exception applies. Consequently, risk averse folk, like most practitioners, opt for the certainty of bankruptcy, thus increasing bankruptcy filings.

E. HOME MORTGAGE RELIEF

As we begin to witness the excesses of home acquisition coming home to roost, and the concomitant subprime mortgage "meltdown," it should not surprise us that borrowers and lenders are seeking to modify home mortgage debt. In fact, recently announced Project Lifeline, a private sector initiative, suggests that members, including some of the largest mortgage lenders, entertain debt modifications, "pause" foreclosures for 30 days, review updated borrower financial information, and establish a modified debt payment plan, in order to keep homeowners in their homes. Under this voluntary program, the parties may agree that if the borrower can fully perform under the modified plan for three consecutive months, then the modifications may become permanent. These modifications often result in what otherwise would be COD income and could hamper the private efforts to stabilize home foreclosures.

On December 20, 2007, the President signed into law the Mortgage Forgiveness Debt Relief Act of 2007, HR 3648. The Debt Relief Act, among other things, amended section 108 of the Internal Revenue Code ("IRC"), title 26, United States Code, and excludes from gross income under IRC 61(a)(12) any COD incurred to acquire a principal residence ("acquisition indebtedness"). The Act inserts the following language as an exception:

> (E) the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2013.

Under the Act, acquisition indebtedness includes the initial loans to acquire, construct, or substantially improve the residence as well as any refinancing of debt to the extent the refinancing does not exceed the amount of the refinanced indebtedness. Furthermore, the term "principal residence" has the same meaning as when used in section IRC §121.

A qualified discharge is one that has occurred prior to 1 January 2013. The new exclusion from the recognition of COD is capped at $2 million. In exchange for the nonrecognition of the COD, a taxpayer must reduce the basis in the principal residence on a dollar-for-dollar basis (but not below zero), thus making the new exception to the general recognition of COD as income a rule of tax deferment and not outright exclusion.

The Act contains special ordering rules. If any loan is discharged, in whole or in part, and only a portion of such loan is qualified principal residence indebtedness, subsection (a)(1)(E) shall apply only to so much of the amount discharged as exceeds the amount of the loan (as determined immediately before such discharge) which is not qualified principal residence indebtedness. Finally, the special exception takes priority over the insolvency exception under section 108.

V. NONREALIZATION OF CANCELLATION OF INDEBTEDNESS INCOME

The BTA substantially modified prior law governing federal income tax treatment of COD income. Congress intended that the BTA effectuate sound bankruptcy and tax policy by setting forth clear rules governing transactions occurring both inside and outside of bankruptcy.[70] Congress also intended to remedy some of the problems arising under prior law, while

[70] H.R. REP. NO. 833 at 8; S. REP. No. 1035 at 9-10, *reprinted in* 1980 U.S.C.C.A.N. at 7024-7025.

simultaneously affording taxpayers a degree of flexibility not previously available to them.[71] Accordingly, the BTA and its amendments changed section 108 to provide that a taxpayer's gross income shall not include amounts realized from the discharge of indebtedness when: (1) the discharge occurs in a title 11 case;[72] (2) the debtor is insolvent immediately before the discharge;[73] (3) the indebtedness is considered "qualified farm indebtedness;"[74] or (4) the indebtedness is considered "qualified real property indebtedness.[75] In addition, there is no indication in the legislative history that Congress intended to reject either the (1) gift exception or the (2) bona fide debt exception to the realization of COD income.

As discussed in previous sections, both case law and the BTA have identified numerous exceptions to the realization of COD income. These exceptions include the following:

- Gifts exception
- Indebtedness subject to bona fide dispute exception
- Lost deduction exception
- Purchase price adjustment

[71] H.R. REP. NO. 833 at 9; S. REP. No. 1035 at 10, *reprinted* in 1980 U.S.C.C.A.N. at 7025.

[72] IRC § 108(a)(1)(A). Thus, it is imperative that any COD occur pursuant to a court order or confirmed plan. Frankel at 290. The BTA defines a title 11 case as a federal bankruptcy case brought under title 11. IRC §108(d)(2). In addition, the taxpayer must be under the court's jurisdiction, and the discharge must be either granted by the court or pursuant to a court-approved plan. Id. The election by a solvent debtor to apply COD income against tax attributes in order to defer the tax consequences, rather than the basis of depreciable assets, is limited to situations where the debt discharge occurs in a title 11 case. This is peculiar considering that the preferential treatment accorded a "G reorganization" is available in a "title 11 or similar case," Id. § 368(a)(l)(G), which includes receiverships, foreclosures, and similar proceedings, whether in federal or state court, Id. § 368(a)(3)(A), as well as certain federal or state agency receivership proceedings involving financial institutions, Id. § 368(a)(3)(D). The House and Senate Committee Reports to the BTA do not describe the rationale behind this disparity, and at least one commentator on the subject asserts there is no justification for it despite a similar difference in treatment under prior law.

[73] IRC § 108(a)(l)(B). The BTA states that other than those exceptions specifically provided in IRC § 108(e), there is no other insolvency exception to the rule that gross income includes debt discharge income. Id. section 108(e)(1). IRC §108 also provides special rules relating to the treatment of COD income by partnerships and Subchapter S corporations. Id. § 108(d)(6)-(7).

[74] Id. § 108(a)(1)(C). Indebtedness qualifies as "qualified farm indebtedness" if:

> such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of framing, and ... 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.

Id. § 108(g)(2)(A)-(B).

[75] Id. § 108(a)(1)(D). The insolvency exclusion takes precedence over the qualified farm or real property indebtedness exclusions, and the title 11 bankruptcy exclusion takes precedence over all three. Id. § 108(a)(2).

- Contribution of capital exception
- Stock-for-debt and Partnership equity-for-debt exceptions

Because many of these exceptions were fashioned from case law and predate the enactment of the BTA, a recurring question is whether the codification of a form of the exception effectively repeals all other variations of the exception. I say no. First, the legislative history to the BTA does not suggest that the codification of, for example, the purchase price adjustment repealed all variations that existed under case law. To the contrary, sufficient statements in the legislative history suggest that to the extent not inconsistent with specific provisions in section 108, case law variations of the exceptions retain their vitality. Second, treating the codification of the exceptions as "safe-harbors" does not disturb the overall purposes of section 108. Third, recognizing the exceptions effectuates sound bankruptcy and tax policy.[76]

A. GIFTS EXCEPTION

Under case law existing prior to enactment of the BTA, no COD income was realized when the cancellation of a debt was intended as a gift.[77] Although essentially nonexistent in the business context, the gifts exception does have application in limited situations.

> **Example 8:** A owes B, her sister, $100. B forgives the debt, characterizing the transaction (or any part thereof) as a gift. If a bona fide gift is intended, no COD income is realized by A.

Interestingly, although the result that no COD income is realized is sensible, the result must be reached outside the statutory language in IRC §108. There is no statutory gift exception or meaningful definition of *discharge of indebtedness* that would shed light on the existence of the exception. One must leave the confines of the statute to reach what all would agree to be a rational result. Thus, the failure of IRC §108 to provide a precise definition of *discharge of*

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[76] For a persuasive discussion on the continued viability of judicial-crafted exceptions to the realization of COD income, particularly in the context of purchase price adjustments, see Stern at A-6.

[77] Tatlock at A-14. For an extended discussion of the gifts exception, see McQueen and Williams.

indebtedness should not affect the conclusion that no COD income is realized even though the original transaction was a loan.

B. INDEBTEDNESS SUBJECT TO BONA FIDE DISPUTE EXCEPTION

Under prior case law, no COD income was realized when the cancellation of indebtedness was a result of a bona fide disputed debt.[78]

> **Example 9:** Taxpayer and Plumber engage in a bona fide dispute over the cost of certain repairs. Plumber claims the cost of repairs totaled $5000. Taxpayer disagrees, asserting a total of $3000. If the parties settle the dispute at $4000, Taxpayer has not generated $1000 of COD income.

Notice that, like the gifts exception, there is no statutory bona fide debt exception or meaningful definition of *discharge of indebtedness* that would resolve the controversy. Again, one must leave the confines of the statute to reach what all would agree to be a rational result. Thus, the failure of IRC §108 to provide a precise definition of *discharge of indebtedness* should not affect our conclusion.

Reviewing the example given, one should notice that a bona fide dispute over the existence of the indebtedness did exist between Taxpayer and Plumber. Contrast that situation with the situation where a dispute exists between Taxpayer and Plumber as to the *collectability* of the indebtedness as opposed to its *existence*. Disputes as to collectability, regardless of the bona fides present, do not fall within the exception.[79]

Two related exceptions arise where a liability is too contingent[80] or is, in fact, an equity infusion rather than the creation of indebtedness.[81] In both situations, any discharge or satisfaction at a discount does not result in the realization of COD income.

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[78] McQUEEN & WILLIAMS § 20.18.

[79] For an extended discussion of the bona fide dispute exception, see McQueen and Williams at § 20.18.

[80] See, e.g., CRC Corp. v. Commissioner, 693 F.2d 281 (3d Cir. 1982), cert. denied, 426 U.S. 1106 (1983); Zappo v. Commissioner, 81 T.C. 77 (1983); see also Stern at A-4 - A-5.

C. LOST DEDUCTION EXCEPTION

Where the payment of a liability would give rise to a deduction such as the payment of interest on a business loan or the payment of trade payables, the discharge of that liability does not result in income realization.[82] Accordingly, no COD income will arise where, for example, a creditor of a cash basis debtor forgives a debtor's liability for unpaid interest on a business obligation.[83] Moreover, where an obligation of the partnership would give rise to a corresponding deduction when paid, no deemed distribution to the partners under IRC §752 occurs. For the most part, this exception to COD income is self-explanatory and supported by sound tax policy. The exception avoids the inconvenience of having to report COD income and an equivalent deduction on a debtor's return.[84]

The lost deduction exception, however, does not apply where an accrual taxpayer has previously taken a deduction for the amount later discharged except where the deduction did not benefit the taxpayer.[85] Thus, an accrual basis taxpayer must realize COD income from the discharge of accrued but unpaid interest, trade payables, or taxes, but only to the extent the taxpayer received tax benefits from the accruals.[86]

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[81] See Stern at A-5. In Selfe v. United States, 778 F.2d 769 (11th Cir. 1985), the court held, that notwithstanding the form of the transaction, a fact issue was generated as to whether a loan to the S corporation guaranteed by a shareholder may be recharacterized as a loan to the shareholder followed by a contribution to the S corporation. For a list of factors courts consider in determining whether an advance to an entity should be characterized as equity or debt, see In re Lane, 742 F.2d 1311 (11th Cir. 1984); Mixon Est. v. United States, 464 F.2d 394 (5th Cir. 1972).

[82] IRC §108(e)(2). See Albert J. Cardinali & David C. Miller, *Tax Aspects of Non-Corporate Single Asset Bankruptcies and Workouts,* 1 AM. BANKR. INST. L. REV. 87, 95 (1993) (stating COD income is not realized if discharged liability would have been deductible).

[83] Cardinali & Miller at 95. This is not the case if the debtor is an accrual basis taxpayer because the deduction for such interest would have already accrued prior to payment. Id.

[84] For an extended discussion on the lost deduction exception, see McQueen and Williams at §20.18.

[85] See Retail Properties, Inc., v. Commissioner, T.C. Memo 1964-245; see also Stern at A-12.

[86] Stern at A-13 - A-14.

D. PURCHASE PRICE ADJUSTMENT

Under IRC section 108(e)(5), any purchase price debt adjustment otherwise resulting in COD income for qualified *solvent* debtors is treated as a purchase price adjustment of the property which was financed, and accordingly, does not generate COD income.[87] The effect of this exception is a reduction in the basis of the purchased property. The stated purpose of this exception is to eliminate disputes between taxpayers and the IRS concerning what debt reductions constitute true purchase price adjustments as opposed to COD income.[88] A pressing question is whether to allow similar treatment for title 11 and insolvent debtors as well. If allowed, taxpayers may avail themselves, in these situations, of the purchase-price exception to the realization of COD income without the requirement of reducing their tax attributes under IRC section 108(b). Possibly, expanding the exception to include insolvent and title 11 taxpayers would go even further in eliminating disputes between taxpayers and the IRS.[89]

A lingering issue is whether section 108(e)(5) completely supplants or augments the judicial purchase price adjustment. Prior to the enactment of the BTA, both the IRS and courts recognized a purchase price adjustment exception to the realization of COD income.[90]

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[87] IRC §108(e)(5). "When a debt arises out of the purchase of property, the discharge may be treated as a reduction of the purchase price, rather than as income." Grant W. Newton and Gilbert D. Bloom, Bankruptcy & Insolvency Taxation 45 (2d ed. 1994).

[88] H.R. REP. NO. 833 at 13, reprinted in 1980 U.S.C.C.A.N. at 56; S. REP. NO. 1035 at 16, *reprinted in* 1980 U.S.C.C.A.N. at 7031.

[89] Neither IRC § 108 nor the committee reports address what should be done when the debt reduction amount exceeds the basis of the applicable property. This situation could arise, for example, when an accelerated depreciation method has been used for the purchased asset, or when the basis of the property has been adjusted downward as a result of a casualty loss. It would seem that the taxpayer would either have to recognize income despite section 108(e)(5) or else reduce the basis of the property below zero. Since a negative basis would be an anomaly in the tax law--an exception is the excess loss account in the consolidated return regulations, Treas. Reg. §1.1502-19 -- income recognition would appear to be the better result here. Such income could presumably be avoided by a qualified debtor's reduction of basis in depreciable property under section 108(a)(l)(C), (c).

[90] See, e.g., Rev. Rul. 91-31, 1991-1 C.B. 19; Rev. Rul. 82-202. 1982-2 C.B. 35; see also Commissioner v. Killian Co., 128 F.2d 433 (8th Cir. 1942); Hextell v. Huston, 28 F. Supp. 521 (S.D. Iowa 1939).

Moreover, in *Fulton Gold Corp. v. Commissioner,*[91] the court held that a discharge of nonrecourse secured indebtedness resulted in a nontaxable reduction in basis of the collateral. For the *Fulton Gold* doctrine to apply, the debtor must have retained the collateral and the debt must have been included in the basis of the property.[92] Although controversial, many commentators assert the continued vitality of the *Fulton Gold* doctrine.[93] Additionally, the IRS examined the continued existence and application of the judicial purchase price adjustment in a Revenue Ruling.[94] Other hints exist that suggest the continued vitality of the judicial purchase price exception.[95]

E. CONTRIBUTION OF CAPITAL EXCEPTION

One of the more dramatic changes to prior law made by the BTA is the contribution-of-capital exception to the realization of COD income.[96] Before enactment of the BTA, courts held that COD income was not realized where a shareholder's debt was cancelled as a contribution of capital.[97] This was the case even where the corporate debt had been previously deducted.[98]

Section 108(e)(6)(A) significantly restricts prior law by providing that when a corporation obtains its indebtedness from a shareholder as a capital contribution, IRC § 118's tax-free treatment shall not apply.[99] A corporate taxpayer is treated as satisfying the debt by an

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[91] 31 BTA 519 (1934).

[92] See generally Stern at A-6.

[93] See, e.g., Green and Sparkman, *Consequences of Discharges of Nonrecourse Indebtedness*, 67 J. Tax'n 18 (July 1987).

[94] Rev. Ruling 92-99, 1992-2 C.B. 35.

[95] See, e.g., Sutphin v. United States, 88-1 USTC &9269 (Cl. Ct. 1988).

[96] IRC §108(e)(6).

[97] E.g., Putoma Corp. v. Commissioner, 66 T.C. 652, 665 (1976), *aff'd, 601 F.2d 734 (5th* Cir. 1979). For a detailed discussion of the exception as it existed prior to the BTA, see MCQUEEN & WILLIAMS § 21.15.

[98] Putoma, 66 T.C. at 665-66.

[99] IRC § 108(e)(6)(A); see H.R. REP. NO. 833 at 15 n.21; S. REP. NO. 1035 at 19 n.22, *reprinted in* 1980 U.S.C.C.A.N. at 7034.

amount of cash equal to the shareholder creditor's adjusted basis in the debt.[100] Thus, the COD rules in IRC § 108 apply only to the excess of the face amount of the obligation over the adjusted basis of the obligation in the hands of the shareholder. Treatment of this face amount will depend upon a corporate debtor's status as a title 11, insolvent, or qualified debtor.[101] While the term "contribution to capital" is not defined in the statute, the Senate Report to the BTA does indicate that a shareholder's cancellation of debt must be related to her status as a shareholder and not to her status as a creditor attempting to recover her claim.[102]

Does the capital contribution exception apply where a partner forgives a debt to the partnership? It would appear that the answer should be yes. The consequences of recognizing the exception should turn on whether the partner forgiving the debt had been allocated all of the debt under IRC §752. If so, then it should follow that only the forgiving partner receives a deemed distribution in cash.[103] However, if the partnership debt has been allocated to all the partners, then all partners receive a deemed distribution in cash[104]

F. STOCK-FOR-DEBT AND PARTNERSHIP INTEREST-FOR-EQUITY EXCEPTION

One of the most controversial issues involving exceptions to the realization of COD income has been the existence and application of the stock-for-debt exception. Stock-for-debt exchanges are an historical exception to the recognition of COD income.[105] Under this

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[100] IRC §108(e)(6)(B).

[101] H.R. REP. No. 833 at 15; S. REP. No. 1035 at 18 n.21, *reprinted in* 1980 U.S.C.C.A.N. at 7033.

[102] S. REP. No. 1035 at 19 n.22, *reprinted in* 1980 U.S.C.C.A.N. at 7034.

[103] IRC §752(b).

[104] Id.

[105] See Commissioner v. Motor Mart Trust, 156 F.2d 122, 127 (1st Cir. 1946) (holding conversion of bonds into stock was not cancellation of indebtedness); Capento Sec. Corp. v. Commissioner, 47 B.T.A. 691,695 (1942) (recognizing stock-for-debt exchange differs from discharge of indebtedness and does not result in realization of gain), *aff'd*, 140 F.2d 382, 385 (1st Cir. 1944) (holding substitution of shares for bonds was recapitalization and not gain); Rev. Rul. 59-222, 1959-1 C.B. 80; Rev. Rul. 59-98, 1959-1 C.B. 76 (discussing exchange of stock and securities in certain reorganizations). "The cases arrived at this result under the somewhat questionable assertion that there was no satisfaction of the debt, but the issuance of the stock instead represented the creation of a new liability

exception, if a corporate debtor issued stock in exchange for debt, no COD income arose even when the stock was worth less than the debt satisfied.[106] The theory that led to the implementation of this exception was that the substitution of stock for debt continued a creditor's interest in the corporate debtor.[107]

The stock-for-debt exception to COD income has been repealed by the Omnibus Budget Reconciliation Act of 1993.[108] The controversial repeal is effective for stock transferred after 1994, except for stock transferred in a title 11 or similar case that is filed before the end of 1993.[109]

Moreover, in 2004, pursuant to The American Jobs Creation Act of 2004, Congress repealed the partnership interest-for-equity exception. Specifically, the Act amended section 108(e)(8) to provide that a debtor partnership that satisfies an indebtedness by transferring a capital or profits interest in the partnership to a creditor will recognize COD income to the extent that the outstanding indebtedness exceeds that fair market value of such partnership interest at the time of the transfer. Moreover, any cancellation of indebtedness income recognized by a partnership under section 108(e)(8) must be allocated to taxpayers that were partners immediately before the transfer. The new provisions apply for COD occurring on or after October 22, 2004.

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to substitute for the old." Asofsky at 600.

[106] Motor Mart, 156 F.2d at 127 (finding such a transaction "a form of payment for the bonds "rather than cancellation of indebtedness).

[107] Mark A. Frankel, *Federal Taxation of Corporate Reorganizations,* 66 AM. BANKR. L.J. 55, 63 (1992).

[108] Pub. L. No. 103-66, § 13226(a), 107 Stat. 312, 487-88.

[109] Id. § 13226(a)(3).

VI. DEFERMENT OF CANCELLATION OF INDEBTEDNESS INCOME: ATTRIBUTE AND BASIS REDUCTION RULES

The deferment of COD income is not cost-free. To the extent COD income is excluded under section 108(a), the COD income must be used to reduce enumerated tax attributes listed in section 108(b)(2).[110] Section 108(b)(2) lists the tax attributes to be reduced in the following order:

> (1) net operating losses for the taxable year of discharge and any net operating loss carryover;
>
> (2) any carryover of general business tax credits under IRC §38;
>
> (3) any minimum tax credits under IRC § 53(b) as of the tax year immediately following the taxable year of discharge;
>
> (4) any net capital-losses for the taxable year of discharge and any capital loss carryovers;
>
> (5) basis in all the taxpayer's property;
>
> (6) any passive activity loss or credit carryover under IRC §469(b) for the taxable year of discharge;
>
> (7) any foreign tax credit carryovers.[111]

Section 108(b)(4) contains ordering rules by which attributes are reduced. Attribute reduction is made after determining any tax for the tax year of discharge in question.[112] Carryovers reduce COD income dollar for dollar. Credits reduce COD income 33 1/3 cents for every dollar of COD income.[113] For net operating losses and capital loss carryovers, the reduction is applied first to the loss occurring during the taxable year of the discharge and subsequently to carryovers in the sequence in which such carryovers arose.[114] For credits, the

[110] IRC § 108(b)(1); See Tatlock at A-19 to A-28(1) (discussing ramifications of attribute reduction); Stern at A-7 - A-8(1).
[111] IRC § 108(b)(2).
[112] IRC § 108(b)(4)(A).
[113] IRC § 108(b)(3)(B).
[114] IRC § 108(b)(4)(B).

reduction is applied in the order the credits would have been applied against tax liability,[115] without regard to any income limitations on the use of the credits.[116]

Because of the forced reduction in attributes, section 108 is theoretically a rule of tax deferment and not outright exclusion. Most often, this is an illusory concept. If any COD income exists after all tax attributes in IRC §108(b) are reduced, the remaining COD income is forever excluded.[117]

Basis reduction under the tax attribute reduction rules is governed by IRC §1017. Several rules should be considered when reducing basis under IRC §108(b)(2)(E). Many of these rules are found in Treasury Regulation section 1.1017-1. First, a reduction in basis must be made in all of a taxpayer's property, both depreciable and nondepreciable property (except cash). Second, reduction in basis is made pro rata. Third, basis of property is adjusted as of the first day of the tax year following the income exclusion. Thus, if a taxpayer expects to transfer property, he or she should undertake to do so before the end of the tax year in which the COD takes place, avoiding basis reduction in the particular property. Fourth, basis of property in the hands of partners is adjusted in the case of cancellation of partnership indebtedness. Fifth, partnership interests may be treated as depreciable property and adjusted, with a corresponding adjustment of partnership property, in certain circumstances. Sixth, for individual partners who file for relief under chapter 7 or 11, the separate tax entity created under IRC §1398 makes the attribute and basis adjustments under IRC §108. Seventh, in certain circumstances, basis remaining in unadministered property, after adjustments, may pass back to the individual debtor

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115 Id. § 108(b)(4)(C).

116 H.R. REP. NO. 833 at 8, S. REP. No. 1035 at 13, *reprinted in* 1980 U.S.C.C.A.N. at 7028.

117 See Kenneth C. Weil, *Effects of Real Property Abandonments in Bankruptcy,* 70 J. TAX'N 358, 358 (1989) (stating that section 108 exclusions operate as deferral only if a tax attribute "that has been reduced could have been used").

at the close of the chapter 7 or 11 bankruptcy case.[118] Eight, basis is reduced only to the extent of the excess of the aggregate of the bases of the property held by the taxpayer immediately after discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.[119] Thus, if the remaining liabilities immediately after the discharge exceed the aggregate basis in property held by the taxpayer immediately after the discharge, then no basis reduction is necessary. However, if the aggregate basis in property held by the taxpayer exceeds the remaining liabilities immediately after the discharge, then basis reduction is necessary to the extent of remaining liabilities.[120]

An insolvent or title 11 taxpayer may elect under IRC §108(b)(5) to reduce the basis of its depreciable property by the amount of COD income before reducing tax attributes under section 108(b).[121] Depreciable property includes any property subject to a depreciation allowance, but only if a basis reduction will also reduce the amount of depreciation or amortization allowable in the period subsequent to the reduction.[122] Furthermore, a taxpayer may elect to include as depreciable property, real property held as inventory.[123] If the election is made, attributes are reduced in the following order:

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[118] See generally Treas. Reg. §1.1017-1.

[119] IRC §1017(b)(2).

[120] However, if a taxpayer elects to reduce basis in depreciable property under IRC §108(b)(5), then the limitation in IRC §1017(b)(2) does not apply.

[121] IRC § 108(d)(5).

[122] Id. § 1017(b)(3)(B).

[123] Id. § 1017(b)(3)(E). The election may either be made on the debtor's return for the taxable year of the discharge or in accordance with any regulations which may be issued, and may be revoked only with the consent of the Secretary of the Treasury. Id. § 1017(b)(3)(E)(ii). If the taxpayer establishes a reasonable cause for failure to file the election with the original return, the election may be filed with an amended return or claim for credit or refund. Temp. Treas. Reg. § 301.9100-14T (as amended in 1992). In addition, when a debtor corporation owns stock in another corporation and both corporations are members of an affiliated group filing a consolidated return for the year of the discharge, the subsidiary's stock is considered depreciable property if the subsidiary consents to a corresponding adjustment to its basis in depreciable property. IRC § 1017(b)(3)(D). Similarly, a partner's interest in a partnership can be depreciable property for this purpose to the extent of that partner's proportionate interest in depreciable property held by the partnership, but only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to that partner. Id. § 1017(b)(3)(C).

1. Tax basis in depreciable property to zero basis;
2. Carryovers and credits (NOLs, capital loss and credits) except foreign tax credits;
3. Tax basis in nondepreciable property up to the point of remaining liabilities;
4. Foreign tax credit carryovers.

In 2009, the American Recovery and Reinvestment Act of 2009 was enacted. The Act included provisions modifying some types of COD treatment under §108. Specifically, §108(i) was added, allowing a taxpayer under certain circumstances, who would otherwise recognize COD income, to file an election with the IRS to defer the recognition of the COD income in 2009 or 2010 over a stated period of time. This new rule is temporary; it permits borrowers to elect to defer the payment of taxes from COD income recognized as a result of certain types "reacquisitions" of "applicable debt instruments" that occur during the 2009 and 2010 calendar years. If a borrower qualifies and files an election under this new law, instead of being required to pay income tax on the COD income entirely in the year of the discharge, the borrower will be permitted to defer and report the COD income ratably over a five-year period beginning in 2014 and extending through 2018. Given that there are no "interest" charges on this deferral, this new provision could offer significant time value of money benefits to borrowers who are otherwise faced with currently taxable COD income. While the election to defer COD income under Code Section 108(i) would seem to be a significant benefit to the debtor, there is a significant "toll charge" that must be taken into account when making this election. Code Section 108 generally provides certain exceptions to the recognition of COD income for insolvency, bankruptcy, qualified farm indebtedness or qualified real property business indebtedness. However, if an election to defer COD income is made by the taxpayer, these general exceptions to the recognition of COD income will not apply to any COD income for the tax year of the election or any subsequent tax year.

VII. SECTION 1398: THE SEPARATE ENTITY RULES

One of the most important provisions of the Bankruptcy Tax Act of 1980 (BTA) is Internal Revenue Code (IRC) § 1398. Essentially, § 1398 creates a separate entity for purposes of federal income taxes in cases where an individual debtor files for relief under chapter 7 or chapter 11 of the Bankruptcy Code. Following is a list of common questions and answers regarding the scope, purpose, and effect of § 1398.

A. WHEN DOES § 1398 APPLY?

Section 1398 applies only when an individual debtor files for relief under chapter 7 or chapter 11 of the Bankruptcy Code. Thus, only the bankruptcy estate of an individual debtor in cases under chapter 7 or 11 is treated as a separate taxable entity. A separate taxable entity is not created in chapters 12 or 13 or in any case where the debtor is not an individual.[124]

B. WHAT IS THE PURPOSE OF § 1398?

Section 1398 furthers the fresh start policy embodied in the Bankruptcy Code. The Committee Reports recognize that the purpose of bankruptcy is to provide for a debtor's ability to begin his or her economic life anew.[125] Congress recognized that any expenses incurred by the estate should not burden a debtor's fresh start. Consistent with this purpose is the fact that the income and losses of a separate taxable entity are computed separately from the individual debtor. Moreover, any estate tax liability is generally confined to the estate and its assets.

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[124] IRC §§ 1398(a), (b), and 1399.

[125] S. Rep. No. 1035, 96th Cong., 2d Sess. 24-25 (1980); see generally Jack F. Williams, ***A Comment on the Tax Provisions of the National Bankruptcy Review Commission Report: The Good, The Bad, and The Ugly***, 5 Am. Bankr. Inst. L. Rev. 445-462 (1997)(symposium); Jack F. Williams, ***National Bankruptcy Review Commission Recommendations on Tax Policy: Individual Debtors, Discharge, and Priority of Claims***, 14 Bankr. Dev. J. 101-171 (1997); Jack F. Williams, ***The Federal Tax Consequences of Individual Debtor Chapter 11 Cases***, 46 S.C. L. Rev. 1203-1244 (1995)(symposium), reprinted in 47 Digest of Tax Articles 23-43 (1996); Jack F. Williams, ***Rethinking Bankruptcy and Tax Policy***, 3 Am. Bankr. Inst. L. Rev. 153-206 (1995)(symposium); see also Robert W. Van Amburgh, ***Tax Considerations For An Individual Debtor Contemplating Bankruptcy***, Annals Bankr. L. 93, 121-28.

Furthermore, by making the short-year election, a debtor may be able to shift at least part of his or her tax liability to the estate as a Bankruptcy Code (BC) § 507(a)(8) priority claim.[126]

C. How is the Bankruptcy Estate Taxed Pursuant to § 1398?

Consistent with its separate entity status, an estate computes its own taxable income in the same manner as an individual.[127] The estate is taxed at the same rate as a married individual filing separately.[128] The chapter 7 or 11 trustee is required to file any returns required by law and to pay any taxes due. The trustee must file a return for each taxable year that the estate's gross income exceeds the standard deduction and the exemption amount.[129]

D. Must a Trustee File a Federal Tax Return Where the Estate Has Generated no Income?

Possibly. The estate may be liable for taxes generated by cancellation of indebtedness income or by sale and exchange (i.e., a foreclosure on property that is property of the estate).

E. How is the Gross Income of a Bankruptcy Estate Determined?

The bankruptcy estate's gross income includes the gross income of the debtor to which the estate is entitled under §§ 541(a)(1) through (a)(7). Property of the estate includes all of the debtor's legal or equitable interest in property wherever located. Section 1398 does not permit double counting of income or losses by both the estate and the debtor. Thus, § 1398(e)(2) provides that a debtor's gross income for any taxable year does not include any item to the extent it is included in the estate's gross income.[130]

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[126] See IRC § 1398(d); see also 1A Collier on Bankruptcy & 9.05 (15th ed. L. King ed.).
[127] IRC § 1398(c)(1).
[128] IRC §§ 1398(c)(2) and (c)(3).
[129] See Van Amburgh.
[130] See generally 1A Collier on Bankruptcy at & 9.04[3].

F. How is Income Treated Where the Income Was Earned Prepetition, But the Income was Received Postpetition?

Section 1398(e)(1) provides that gross income of the estate does not include any amount received or accrued by the debtor before the commencement of the case. Thus, § 1398 was intended to override the assignment-of-income principles under tax law. An example may clarify the effect. Assume that a cash-basis individual who draws a weekly salary nonexempt under applicable state law earns one payment prior to the commencement of his or her chapter 7 case, but it is received by the estate after commencement. In that case, the estate and not the debtor would report the income.[131]

G. How is Cancellation of Indebtedness Income Treated Under the Separate Entity Rules?

Whether the debtor or the estate reports cancellation of indebtedness income will depend on when the taxable event occurs. If the taxable event, e.g., complete or partial discharge, modification of principal amount, etc, occurs before the commencement of the case, generally the debtor should recognize the income under § 61(a) unless it can be excluded under § 108(a). (There is a means by which to shift at least some of the tax consequences from the debtor to the estate through a § 1398 short-year election by the debtor). If the taxable event occurs after commencement of the case, then the estate should recognize the income under § 61(a) unless it can be excluded under § 108(a).

H. How are Deductions Treated Under the Separate Entity Rules?

Section 1398(e)(3) provides that the determination whether any amount paid or incurred by the estate is allowable as a deduction shall be made as if paid by the debtor and the debtor was still engaged in the trade or business that the debtor was engaged in before the commencement of

[131] See Van Amburgh at 123 (provides examples of cash-basis and accrual-basis debtors).

the case. It would appear that the same accounting method used for income should be used for deductions. Additionally, § 1398(e)(3) permits the estate to characterize some of its expenditures as trade or business expenses which can be used to offset current income of the estate. Furthermore, administrative expenses and any fees under chapter 123, Title 28, United States Code, are deductible by the estate to the extent not disallowed under another IRC section.[132] If the administrative expenses cannot be used in the current year then they may be carried back three years and carried forward seven years.[133]

I. ARE TRANSFERS OF ASSETS BETWEEN THE DEBTOR AND THE ESTATE TAXABLE EVENTS?

No. Transfers of assets from the debtor to the estate upon commencement of the case and from the estate to the debtor upon termination of the estate are not taxable events.[134]

J. DOES THE ESTATE SUCCEED TO THE DEBTOR'S TAX ATTRIBUTES?

Yes. The estate succeeds to certain enumerated tax attributes of the debtor upon commencement of the case.[135] Presently, these tax attributes include net-operating loss carryovers as determined under IRC § 172; excess charitable contribution carryovers as determined under IRC § 170(d)(1); the recovery of tax benefit items under IRC § 111; certain credit carryovers; capital loss carryovers determined under IRC § 1212; the basis, holding period, and character of property; the debtor's method of accounting; and other tax attributes of the debtor, to the extent provided in regulations carrying out the purposes of § 1398.[136] The

[132] IRC § 1398(h)(2).
[133] IRC § 398(h)(2)(C).
[134] IRC § 1398(f).
[135] See IRC § 1398(g).
[136] See C. Richard McQueen and Jack F. Williams, Tax Aspects of Bankruptcy Law and Practice (2nd ed. 2002)(helpful explanation of the listed attributes).

Service has issued regulations adding passive activity losses and credits to the list[137] and the §121 exclusion of gain from the sale of a personal residence transferred to the estate.[138] Upon termination of the estate, any unused attributes are transferred back to the debtor.[139]

K. WHAT IS A "SHORT-YEAR" ELECTION? HOW IS THE ELECTION MADE?

Section 1398(d)(2) creates an election that a debtor may make to split his or her taxable year into two taxable years. This election is an important pre-bankruptcy planning tool that cannot be overlooked. The first taxable year-ends on the day before the day the bankruptcy case was commenced.[140] The second taxable year begins on the commencement date. Assume an individual debtor files for relief under chapter 7 on March 8 and shortly thereafter makes the IRC § 1398(d) election. As a consequence of the election, the debtor has two tax years. The first year spans from January 1 through March 7; the second year spans from March 8 through December 31. If the election is not made the debtor would have one taxable year spanning from January 1 through December 31. In other words, absent the election, the commencement of the case will not interrupt the debtor's taxable year.[141] The short-year election is considered made if the complete tax return for the short period is timely filed.[142] In our working example, the return for the short period ending March 7 should be filed by July 15. The debtor should conspicuously write "SECTION 1398 ELECTION" at the top of the return.[143]

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[137] See Treas. Regs. §§ 1.1398-1 and 1.1398-2.

[138] See Treas. Reg. §1.1398-3.

[139] IRC § 1398(I).

[140] A bankruptcy case is commenced upon the filing of the petition under BC §§ 301, 302, 303, and 304.

[141] See IRC § 1398(d)(1). The debtor cannot make the short-year election if he or she has no assets other than exempt property. IRC § 1398(d)(2)(C).

[142] See Temp. Treas. Reg. § 7a.2(d) (1981); Treas. Reg. § 1.6081-1(b)(2).

[143] Temp. Treas. Reg. § 7a.2(d) (1981). For an excellent discussion on requesting extensions to file the short-year return, see 1A Collier on Bankruptcy at & 9.05[b]. See generally James I. Shepard, The Trustee's Bankruptcy Tax Manual 157-58 (1999).

L. WHEN MUST THE SHORT-YEAR ELECTION BE MADE BY A DEBTOR?

The short-year election must be made by the debtor on or before the date for filing his or her return for the short-taxable year.[144] IRC § 6072 requires that returns be made on or before the fifteenth day of the fourth month following the close of a fiscal year. A Treasury Regulation places a gloss on § 6072 in this context by requiring that the short-term return be filed on or before the fifteenth day of the fourth full month following the close of the taxable year.[145] Again, the election must be made on the return. Once made, the election is irrevocable.[146]

M. WHAT IS THE EFFECT OF MAKING THE SHORT-YEAR ELECTION?

The short-year election may be the most potent pre-bankruptcy planning tool because of its wide availability to individual debtors. The most significant effect of the election is that any tax liability for the first short-year becomes an allowed BC § 507(a)(8) priority claim against the estate. Thus, the debtor may essentially force his or her unsecured creditors to pay all or a portion of the first short-year tax claim. Of course, if there are insufficient assets to pay the short-year tax claims in full, they do survive the bankruptcy as a non-dischargeable claim under BC § 523(a)(1). If the debtor fails to make the election, then any tax liability for the complete year is not an allowable claim against the estate.[147] Moreover, if a debtor makes the election, then a debtor's tax attributes as of the end of the first taxable year are transferred to the estate to be used by the estate to shelter income. If the election is not made, a debtor's tax attributes as of the end of the full taxable year carryover.

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[144] IRC § 1398(d)(2)(D).
[145] Temp. Treas. Reg. § 7a. 2(d).
[146] IRC § 1398(d)(2)(D).
[147] See S. Rep. No. 1035, 96th Cong., 2d Sess. 26 (1980).

N. WHEN IS IT ADVISABLE FOR A DEBTOR TO MAKE THE SHORT-YEAR ELECTION? WHEN IS IT NOT?

There is no easy answer to the questions posed. Whether a debtor should make the IRC § 1398 election depends on the particular facts and circumstances at hand. As a general rule it appears that in most cases the election should be made.[148] By making the election, a debtor is able to shift at least some of the tax liability to the estate as an allowable BC § 507(a)(8) priority claim. However, if the claim is not satisfied it will be nondischargeable and survive the bankruptcy. There may be circumstances present to dissuade a debtor from making the election when substantial net operating losses are involved. For example, if the debtor will benefit more from (I) the use of a net operating loss carried forward from the first short year (if he makes the election) to directly or indirectly reduce nondischargeable tax liabilities than from (ii) the use of the net operating loss against projected income of the debtor after the filing of the petition, then the election should be made. Otherwise the election should not be made.[149]

Nondischargeable taxes are the antithesis of an individual's fresh start. Yet, the drafters of the Bankruptcy Code struck the synthesis in favor of the taxing authorities at least as to those tax claims identified in § 523(a)(1). Nevertheless, all is not lost for an individual debtor and his or her bankruptcy counsel in reducing possible tax consequences in contemplation of a bankruptcy filing. Although experience has shown that an individual debtor should most often make the short-year election, there are many instances where the election should not be made. Counsel must be aware of when a debtor should make the election and when a debtor should not. Often times, there are no easy rules, no easy answers. Nevertheless, § 1398 with all its nuances and ramifications cannot be ignored before and during bankruptcy.

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[148] Van Amburgh at 144; see also Shepard at 150-57.
[149] Van Amburgh at 145; see also 1A Collier on Bankruptcy at & 9.05[3]; Shepard at 150-157.

Example 10: THE MALPRACTICE TRAP

Example 10-1: A partnership applies for relief under chapter 7. May the partnership make a § 1398 election? *No. Only individual debtors may benefit from IRC § 1398. See IRC § 1399.*

Example 10-2: Elrod, a partner in the partnership identified above, seeks relief under chapter 13. May Elrod benefit from the § 1398 election. *No. An individual debtor must file for relief under chapter 7 or 11 only to benefit from § 1398.*

Example 10-3: Assume Debtor is a cash basis taxpayer with a calendar year tax year (January 1 – December 31). Debtor filed for chapter 7 bankruptcy relief on August 1, 20XX. In the seven months before the commencement of a bankruptcy case, Debtor had income giving rise to a tax of $25,000. *If Debtor fails to make the election, there is no interruption in her tax year. The tax would be due at the end of her tax year (31 December) and payable by the fifteenth day of the fourth month following the close of her tax year (15 April). The tax claim would not participate in the chapter 7 distribution in that it is a postpetition claim. However, it would not be discharged in the chapter 7 case. If the Debtor makes the election, she will have two tax years. The first short year runs from 1 January to 31 July. The second runs from August 1 to December 31. Now, the postpetition claim magically becomes a prepetition one due as of the end of the new short tax year. This is also a § 507(a)(8) priority claim that is nonetheless not subject to discharge as delineated in § 523(a).* ***Practice pointer: Make the election.***

Example 10-4: Same facts as above. However, in the previous tax years, Debtor had generated net operating losses (NOLs) that can be carried forward or back to other tax years. An NOL is a surplus deduction that tax law allows you to apply to other tax years. *If Debtor does not make the election, then these tax attributes will pass to the bankruptcy estate and can be used by the trustee to reduce the estate's tax liability. Any unused losses would then pass back to Debtor upon termination of the case. If Debtor makes the election, then she is entitled to use them herself.* ***Practice pointer: Make the election.***

Example 10-5: Same facts as above except that the NOLs arose in the seven months preceding the commencement of the case. Further assume that she had no income in the first seven months of the tax year and expects substantial income in the last five months of the year. *Without the election, Debtor will be able to use the deductions against postpetition income. With the election, the bankruptcy trustee gets to use the losses and Debtor's income cannot be offset by the deductions.* ***Practice pointer: Do not make the election.***

VIII. PRIORITIES AND DISCHARGE

A. SCOPE OF DISCHARGE

An individual's most important bankruptcy objective is a discharge from his or her debts.[150] The discharge is at the heart of the fresh start policy promoted by the Bankruptcy Code and the BTA. The chapter 7 discharge is granted virtually automatically unless an objecting party can establish that the debtor has engaged in prohibited conduct, usually constituting some type of fraud or bankruptcy crime.[151] The statute providing for discharge is liberally construed in favor of an individual debtor.[152] Thus, the objecting party has the burden of establishing a ground for the denial of a discharge.[153]

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[150] See generally Douglas G. Baird, The Elements of Bankruptcy 27-44 (1992) (discuss fresh start policy); David G. Epstein, Steve H. Nickles, & James J. White, 2 Bankruptcy 7-16 (1993)(same).

[151] See 11 U.S.C. 727(a)(1) through (a)(10).

[152] Accord *In re Adeeb*, 787 F.2d 1339 (9th Cir. 1986); *In re Johnson*, 98 BR 359 (Bankr. N.D. 1988); *In re Cutignola*, 87 BR 702 (Bankr. M.D. Fla. 1988); *In re Burke*, 83 BR 716 (Bankr. N.D. 1988); *In re Drenckhalm*, 77 BR 697 (Bankr. D. Minn. 1987); *In re Howard*, 55 BR 580 (Bankr. E.D.N.C. 1985).

[153] If a debtor has been denied a discharge in a bankruptcy case, so that all his or her debts remain outstanding, the debtor may not include the same obligations in a subsequent case to obtain a discharge. The denial of the discharge is *res judicata* as to the obligations existing at that time, which are forever nondischargeable. Although understood as part of the warp and wolf of bankruptcy law, the right to discharge was not a part of the early enactments of bankruptcy acts in the United States. The Supreme Court noted the comparative newness of the discharge and fresh-start policy in bankruptcy in *United States v. Kras*, 409 U.S. 414, 446-47 (1973). In fact, it was not until the enactment of the Bankruptcy Act of 1898 that the law provided an individual debtor with a right to discharge certain debts pursuant to the bankruptcy process. Moreover, contrary to conventional wisdom, there is no constitutional right to a discharge; discharge is a statutory privilege provided to the honest but unfortunate debtor who has not abused the bankruptcy process. See *In re Wheeler*, 101 BR 39 (Bankr. N.D. Ohio 1988). A discharge in a bankruptcy case voids any judgment to the extent that it is a determination of the personal liability of the debtor with respect to a prepetition debt. See 11 U.S.C. § 524(a). The discharge also operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, including telephone calls, letters, and personal contacts, to collect, recover, or offset any discharged debt. Id. In effect, the discharge is a total prohibition on debt collection efforts against a debtor. However, a discharge of the debtor does not discharge those liable on the debt along with the debtor, including guarantors, co-makers, or partners. 11 U.S.C.§ 524(e). Furthermore, under BC § 524, any attempt to reaffirm a discharged debt is void unless the provisions of the Bankruptcy Code delineating the requirements of reaffirmation are specifically followed. See 11 U.S.C. § 524(c). To ensure the effectiveness of the discharge, § 525(a) prohibits a governmental unit from denying, suspending, or refusing to renew a license or permit or deny employment solely because the person involved was discharged under the Bankruptcy Code, was insolvent before the bankruptcy case, or has not paid a dischargeable debt. Additionally, under § 525(b), no private employer may terminate the employment of, or discriminate with respect to employment against, an individual who is or has been a debtor under the Code, or an individual associated with a debtor under the Code, solely because the debtor is or has been a debtor under the Code, was insolvent before the commencement of case under the Code, or has not paid a debt that is dischargeable under the Code. See generally D. Epstein, S.

Under chapter 11, § 1141(d) governs the scope and limits of discharge. Pursuant to BC § 1141(d), the confirmation of a plan of reorganization discharges a debtor from any debt that arose before the confirmation of the plan. Unlike § 727(a), a partnership, corporation, or an individual may receive a § 1141(d) discharge.[154] The § 1141(d) discharge is broader than the § 727(a) discharge in that the latter discharges any debts that arose[155] before the *order for relief*,[156] while the former discharges any debts that arose before the *confirmation of the plan*.[157]

B. EXCEPTIONS OF DEBT FROM DISCHARGE

Notwithstanding the debtor's discharge under the Code, certain debts are excepted from discharge as a matter of public policy pursuant to § 523(a). These exceptions to discharge are strictly construed. An exception to discharge should be contrasted with an objection to discharge. If successful in an objection to discharge proceeding, the creditor's claim along with every other claim survives the bankruptcy case; that is, the debtor will not receive a discharge at all. It is significantly different with an exception to discharge proceeding under § 523(a). If successful in asserting § 523(a), the creditor's claim will not be discharged and will survive the bankruptcy case; that is, a § 523(a) claim may be enforced and ultimately satisfied even after the bankruptcy case. Thus, although the debtor receives a general discharge, the § 523(a) claims live on.

The burden of proof to assert that the debt is non-dischargeable under § 523(a) falls squarely on the shoulders of the creditor asserting the exception. Among the types of claims that

Nickles, & J. White at 7-40.

[154]In *Toibb v. Radloff*, 111 S. Ct. 2197 (1991), the Supreme Court held that an individual may properly seek relief under chapter 11 of the Bankruptcy Code.

[155]It should come as no surprise that just when a debt arises has become a bone of contention. D. Epstein, S. Nickles, & J. White 7-16, at 312.

[156]The order for relief is entered automatically where a debtor files a voluntary petition in bankruptcy. See 11 U.S.C. § 301. In an involuntary case, the order for relief comes after the court is persuaded that the grounds for involuntary relief are met. See 11 U.S.C. § 303(h).

[157]For the requirements for chapter 11 plan confirmation, see 11 U.S.C. § 1129.

are nondischargeable are current year taxes and taxes for which the due date falls within three years of the filing of the bankruptcy petition.[158] The following tax debts are excepted from discharge under § 523(a) as a matter of law:

- Taxes entitled to priority under §§ 507(a)(2) and (a)(8).
- Taxes connected with failure to file returns, late returns, fraudulent taxes or taxes associated with a willful attempt to evade or defeat a tax.
- Withholding taxes and taxes collected from others, that is, trust fund taxes.
- Debts that are not scheduled in time for the timely filing of the proof of claim.
- Governmental fines and penalties to the extent that they are not compensation for actual pecuniary loss. Nonetheless, this category of non-dischargeable debt does not include tax penalties relating to dischargeable taxes or to any transaction or event that occurred more than 3 years before the filing of the bankruptcy petition.

Section 523 of the Bankruptcy Code generally specifies which debts of an individual debtor are not discharged in a bankruptcy case under § 727 of chapter 7, § 1141 of chapter 11, or § 1328(b) of chapter 13 (the "hardship discharge).[159] Included among theses debts are certain taxes which are identified as nondischargeable.[160]

Section 523(a)(1) of the Bankruptcy Code sets forth the taxes or customs duties that are not dischargeable by an individual debtor in a chapter 7, 11 or 13 bankruptcy case under §§ 727, 1141 or 1328(b)(chapter 13 "hardship discharge"), respectively. However, the regular chapter 13 super-discharge does discharge debts identified under § 523(a).[161]

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[158] 11 U.S.C. §§ 523(a)(1), 507(a).

[159] However, these taxes may be discharged in a chapter 13 under § 1328(a),i.e., the chapter 13 super-discharge.

[160] In *In re Olsen*, 123 B.R. 312 (Bankr. N.D. Ill. 1991), the bankruptcy court held that a nondischargeable tax claim survives bankruptcy regardless of whether such claim was filed or allowed in the bankruptcy case.

[161] See 11 U.S.C. §1328(a).

The first category of nondischargeable tax claims is set forth in § 523(a)(1)(A).[162] This category also happens to include the priority tax claims. Under this section, a tax or customs duty specified in § 507(a)(2) as an involuntary gap claim[163] or § 507(a)(8)[164] is nondischargeable whether or not a claim for such tax was allowed by the court or filed in the case.[165] These priority and nondischargeable tax claims include the following:

1. Involuntary gap claims under § 507(a)(2).[166]
2. Income or gross receipts taxes incurred (that is, measured by the last date by which a return could be filed without penalty) prepetition and within three years from the filing of the bankruptcy petition.[167] An easier approach is to applying this rule is to go back three years from the petition date and look forward. Any subsequent return due date (including extensions) that can be "seen" as one looks "into the future" will mean

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[162] 11 USC § 523(a)(1), which reads as follows:

A discharge under section 727, 1141, or 1328(b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, if required--

(i) was not filed; or

(ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

[163] 11 U.S.C. § 523(a)(1)(A); 11 USC § 507(a)(2)(this section relates to the priority of involuntary gap claims).

[164] 11 U.S.C. § 523(a)(1)(A); 11 USC § 507(a)(8)(this section relates to the priority of allowed unsecured tax claims of governmental units)

[165] 11 USC § 523(a)(1)(A).

[166] The second priority as set forth in § 507(a)(2) of the Bankruptcy Code is "unsecured claims allowed under § 502(f) of this title." Under § 502(f), an involuntary gap claim is one which arises in the ordinary course of a debtor's business after the filing of an involuntary petition against the debtor but before either the appointment of a trustee or the entry of an order for relief. An involuntary gap claim is allowed "the same as if such claim had arisen before the date of the filing of the petition." The involuntary gap claim is the creature of the involuntary bankruptcy case. Recall from chapter 1 that the filing of an involuntary petition against the debtor does not operate as an order for relief under the Bankruptcy Code. This priority speaks directly to the time delay made possible by segregating the order for relief from the filing of the petition.

[167] An eighth priority is allowed by § 507(a)(8)(A)(i) of the Bankruptcy Code for unsecured federal tax liens ("unsecured claims of governmental units") to the extent that such claims are for income or gross receipts taxes incurred before the filing of the bankruptcy petition for which the due date of the tax return (including any extension) occurred within three years before the date the bankruptcy petition was filed or for which the due date of the return (including any extensions) occurred after the filing of the petition. As indicated, the due date of the return, and not the date when the taxes are assessed, determines the priority.

that the taxes associated with that tax year are nondischargeable. Moreover, it is the first petition date and not any conversion date that constitutes the measuring date. Under § 507(a)(8), the three-year period is suspended if the automatic stay is in effect. Thus, a debtor cannot hide in a chapter 13 case for the purpose of "running out" the three year clock. Once the stay is no longer in effect, the clock begins to run again at the place at which it last stopped plus an additional ninety days. A practitioner should order the tax history (MFTRA-X) of her client to ascertain when returns were due, including extensions filed. One can request that information through calling the Tax Practitioner Hotline at 866-860-4259 or by ordering on-line through the E-Services for Tax Professionals Portal.

3. Income or gross receipts taxes assessed within 240 days from the filing of the bankruptcy petition.[168] This will require the practitioner to obtain evidence of the assessment date, if any. For federal taxes, one can obtain a proof of assessment by requesting a Form 23-C Assessment Certificate, the MFTRA-X tax history , or the From 4340 Certificate of Assessments and Payments.

4. Income or gross receipts taxes still assessable under applicable law at the time the bankruptcy petition is filed.[169] These taxes generally include those years that are still under audit risk, tax issues pending in the Tax Court, and taxes associated with a Form 872-A Consent to Extend Time for Assessment (open ended).

5. Recent property taxes assessed prepetition and last due without penalty within one year of the filing.[170]

6. Trust fund taxes incurred at any time, including the *employee's share* of payroll taxes that an employer is required to withhold and, in many states, sales tax.[171]

7. The *employer's share* of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition to the extent the return for such taxes was last due (including any extensions of time)

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[168] Also included are income and gross receipts taxes assessed at any time within 240 days before the date the bankruptcy petition was filed. The 240-day period is extended for the period of time an offer of compromise is considered by the IRS after submission by the taxpayer, plus 30 days after such offer is rejected. Under this rule, the date on which the IRS assesses the tax, rather than the date of the return, determines the priority.

[169] Section 507(a)(8)(A)(iii) grants priority to income and gross receipts taxes not assessed before the filing of a bankruptcy petition, but which are still permitted to be assessed under applicable tax laws. Accordingly, a prepetition and unsecured federal tax lien will still receive a seventh priority under this section if the statute of limitations still allows an assessment of the tax liability after the bankruptcy petition is filed, even though such assessment was not made within the 240-day period (plus any extension) prior to the bankruptcy filing.

[170] An unsecured claim of a governmental unit for property taxes assessed before the bankruptcy petition was filed and last payable without penalty within one year before the filing of the petition is given an eighth priority.

[171] Taxes required to be collected or withheld and for which the debtor is liable in whatever capacity are given an eighth priority under § 507(a)(8)(C) of the Bankruptcy Code.

within three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed[172]

8. Excise taxes related to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition.[173]

9. Certain customs duty under § 507(a)(8)(F) of the Bankruptcy Code[174]

The second category of nondischargeable tax claims is set forth in BC §§523(a)(1)(B) and (C) and include the following taxes:

1. Tax liabilities relating to a tax return which was not filed.[175] There have been several cases that have struggled with what constitutes a "return" for these purposes. BAPCPA has now defined a return by reference to applicable nonbankruptcy law. Thus, for federal income tax purposes, a return includes a §6020(a) return where a taxpayer signs it, a written stipulation to a judgment, and a final order by a court of competent

[172] The employer's share of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition receives an eighth priority under § 507(a)(8)(D) of the Bankruptcy Code, to the extent the return for such taxes was last due (including any extensions of time) within three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed. Older tax claims of this nature are payable as nonpriority general claims. Likewise, the employee's share of employment taxes on wages earned from a debtor and paid before the filing of a bankruptcy petition also receives an eighth priority in the same manner as the employer's share of employment taxes.

[173] Unsecured claims for excise taxes are given an eighth priority under § 507(a)(8)(E) of the Bankruptcy Code. The excise taxes claimed must relate to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition. If a return is due, the three year period is extended if the due date for filing the return was extended. 11 U.S.C. § 507(a)(8)(E). If a return is not required, the tax claim must relate to a transaction which itself occurred within three years prior to the filing of the bankruptcy petition. For purposes of this priority, excise taxes covered include sales taxes, estate and gift taxes, gasoline and special fuel taxes, wagering taxes, and truck taxes.

[174] Unsecured claims for customs duty are given an eighth priority under § 507(a)(8)(F) of the Bankruptcy Code. According to the legislative history, this priority covers duties on imports entered for consumption within one year before the filing of the petition, but which are still unliquidated on the petition date; duties covered by an entry liquidated or unliquidated within one year before the petition date; and any duty on merchandise entered for consumption within four years before the petition but not liquidated as of the petition date, if the Secretary of the Treasury or his or her delegate certifies that duties were not liquidated because of possible assessment of antidumping or countervailing duties or fraud penalties.

[175] See, e.g., *In re Bergstrom*, 949 F.2d 341 (10th Cir. 1991), where the United States Court of Appeals for the Tenth Circuit held that the term "filed return" was not broad enough to include a substitute return prepared by the IRS, absent the debtor's signature thereon; *In re Pruitt*, 107 B.R. 764 (Bankr. D. Wyo. 1989), where the bankruptcy court held that substitute tax returns filed by the Internal Revenue Service when the debtor failed to file such returns for several years did not preclude application of the Bankruptcy Code rendering tax debts nondischargeable for any tax debt with respect to which a return was required and not filed; *In re Brookman*, 114 B.R. 769 (Bankr. M.D. Fla. 1990), where the bankruptcy court held that the debt for unpaid income taxes was nondischargeable because the debtor failed to rebut prima facie evidence that the tax return for the applicable tax year was not filed; *In re Crawford*, 115 B.R. 381 (Bankr. N.D. Ga. 1990), where the bankruptcy court held that a tax obligation for which the debtor did not file a tax return is non-dischargeable even though the Internal Revenue Service filed the return on the debtor's behalf.

jurisdiction. However, a SFR or Substitute for Return prepared by the IRS, any return where the jurat has been altered or the return is unsigned, or any return filed in the wrong place do not constitute a return for these purposes. May a taxpayer file a return after the Service has prepared an SFR and meet eh return requirement. Five circuits have concluded no.

2. Tax liabilities reported by a tax return filed late <u>and</u> filed within two years prior to the filing of the bankruptcy petition or filed after the bankruptcy petition;

3. Tax liabilities reported by a fraudulent return[176] or from an attempt by the debtor to willfully evade or avoid any tax.[177] Here, the courts have employed the civil and not criminal fraud standards. However, there are several approaches that do diverge in the hard cases. Generally, the government must prove some conduct on the p[art of the debtor and a requisite state of mind. To satisfy the conduct requirement, courts look to something more than the failure to pay the tax. For example, the recurrence of an understatement of income, inadequate records, asset transfers, false W-4's, no returns filed, barter transaction history, cash business history, and other forms of concealment may be sufficient to meet the conduct test. As for the state of mind requirement, the civil standard usually mirroring the IRC §6672 responsible person standards for the imposition of trust fund liability are sufficient. Thus, an intentional, knowing, and voluntary act is all that is necessary. In a joint return

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[176] 11 USC § 523(a)(1)(B); *see* 124 Cong. Rec. H11, 113-14 (daily ed Sept 28, 1978); S 17,430-31 (daily ed Oct 6, 1978); *see also In re Graham*, 108 B.R. 498 (Bankr. E.D. Pa. 1989), where the bankruptcy court held that a prepetition tax court decision holding the debtor liable to the IRS for the debtor's underpayment of taxes, but which did not decide that the underpayment was fraudulent, did not preclude the debtor from disputing the government's claim that such tax liabilities were non-dischargeable for fraud; *In re Fernandez*, 112 B.R. 888 (Bankr. N.D. Ohio 1990), where the bankruptcy court held that the debtor's conduct concerning tax obligations was shown to be willful and evasive and thus, the tax obligations were deemed nondischargeable; *In re Kirk*, 114 B.R. 771 (Bankr. N.D. Fla. 1990), where the bankruptcy court held that the debtors' conduct demonstrated a purposeful attempt to evade income taxes and thus, the claim of the IRS for civil fraud penalties was allowed; *In re Carapella*, 115 B.R. 365 (N.D. Fla. 1990), where the district court held that the tax liability of a chapter 7 debtor for a fraudulent return filed by the debtor was nondischargeable; *In re Gilder*, 122 B.R. 593 (Bankr. M.D. Fla. 1990), where the bankruptcy court held that where the debtor submitted false withholding statements for the express purpose for eliminating the withholding of federal income taxes from wages, such conduct was a "willful attempt to evade or defeat tax" within the meaning of the exception to discharge; *In re Hopkins*, 133 B.R. 102 (Bankr. M.D. Ohio 1991), where the bankruptcy court held that the wife's signing of joint returns which she knew were in error constituted the making of a fraudulent return or willfully attempting to evade such tax and, thus, such tax debts were nondischargeable in the wife's bankruptcy case; *In re Peterson*, 132 B.R. 68 (Bankr. D. Wyo. 1991), where the bankruptcy court held that the debtor did not "willfully" attempt to evade tax by signing returns which the government admits were not fraudulent and then filing for relief under chapter 7 shortly after such taxes became eligible to be dischargeable; *In re Graham*, 973 F.2d 1089 (3d Cir. 1992), where the United States Court of Appeals for the Third Circuit held that a United States Tax Court judgment holding the debtors liable for income tax deficiencies resulting from fraudulent tax returns did not have claim preclusion or issue preclusion effect in determining whether the debtors' liability was nondischargeable; *In re Levinson*, 969 F.2d 260 (7th Cir. 1992), where the United States Court of Appeals for the Seventh Circuit held that the evidence was sufficient to support a determination that the debtor had filed fraudulent tax returns so as to render the tax debts nondischargeable.

[177] 11 U.S.C. § 523(a)(1).

situation, the state of mind of one spouse will not be imputed to the other spouse.

The third category of nondischargeable taxes is set forth in § 523(a)(7).[178] This section provides that tax penalties which are basically punitive in nature are nondischargeable only if the penalty is computed by reference to a related tax liability which is also nondischargeable. It appears that if the amount of the penalty is not computed by reference to a tax liability, the transaction or event giving rise to the penalty must occur during a three-year period ending on the date of the filing of the bankruptcy petition.[179]

With respect to individual debtors in reorganization under chapter 11, § 1141(d)(2) of the Bankruptcy Code incorporates by reference the exceptions to discharge set forth in § 523 and discussed above.[180] Section 1141(d)(2) of the Bankruptcy Code provides that the confirmation of a chapter 11 plan does not discharge an <u>individual debtor</u> from any debt excepted from discharge under § 523.[181]

With respect to all debtors (i.e., including corporations and partnerships), the confirmation of a chapter 11 plan does not discharge the debtor from any debts (including taxes) if:

1. The plan provides for the liquidation of all or substantially all of the property of the estate
2. The debtor does not engage in business after consummation of the plan

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[178] 11 USC § 523(a)(7), which reads as follows:

(a)A discharge under Section 727, 1141, or 1328(b) of this title does not discharge an individual debtor from any debt--

(7)to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty-

(A)relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B)imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.

[179] 124 Cong Rec H11, 113-14 (daily ed Sept 28, 1978); S 17,430-31 (daily ed Oct 6, 1978); see also Rev Rul 68-574, 1968-2 CB 595.

[180] 124 Cong. Rec. H11, 113-14 (daily ed Sept 28, 1978); S. 17,430-31 (daily ed Oct 6, 1978).

[181] 11 USC §§ 1141(d)(2) and 523.

3. The debtor would be denied a discharge under § 727(a) of the Bankruptcy Code if the case were a chapter 7 liquidation proceeding[182]

Thus, a debtor is not discharged from any debt (including federal taxes) by the confirmation of a plan if the plan is a liquidation plan and if the debtor would be denied a discharge in a chapter 7 liquidation proceeding pursuant to § 727(a) of the Bankruptcy Code.[183] Under § 727(a)(1), only an individual, and not a corporation or a partnership, may obtain a discharge.[184]

Prior to 2005, the chapter 13 discharge was sufficiently broad in scope that most tax claims could be discharged, even those under §523(a). However, BAPCPA changed that result, conforming the chapter 13 discharge wit that under chapter 7. Thus, after a debtor has made all payments required by the chapter 13 plan, the bankruptcy court grants to the debtor a discharge of all debts provided for by the plan or disallowed under § 502, except the following debts:

1. Debts with the final payment falling due <u>after</u> the final payment under the plan is due as set forth in § 1322(b)(5), that is, certain long-term debt;[185]
2. Debts in the form of trust fund taxes; nonfiler taxes; fraudulent taxes or taxes arising from a willful intent to evade; debts incurred under false pretenses; unlisted debt; debts from fraud, etc., when in a fiduciary capacity; domestic support obligations; certain student loans that do not pose an undue hardship to the debtor; debts for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft while intoxicated;
3. Debts for restitution included in a sentence on the debtor's conviction of a crime;[186] and
4. Debts for restitution or damages awarded in a civil action against the debtor as a result of willful or malicious injury by the debtors that caused personal injury to an individual or the death of an individual.

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[182] <u>Id.</u> § 1141(d)(3).
[183] S Rep No 989, 95th Cong, 2d Sess 129 (1978).
[184] 11 U.S.C. § 727(a)(1).
[185] 11 U.S.C. § 1328(a)(1).
[186] 11 U.S.C. § 1328(a).

IX. CONCLUSION

Both business and consumer bankruptcies regularly pose challenging tax issues. Many of these issues are often overlooked, much to the detriment of our bankruptcy clients. Fortunately, more attention is paid to tax issues in the bankruptcy context than even ten years ago. These materials are designed to aid you in the robust representation of your client. Best of luck.

APPENDIX

OVERVIEW OF TAX PROVISIONS OF THE BANKRUPTCY ABUSE AND CONSUMER PROTECTION ACT OF 2005 ("2005 ACT")

Effective Date

Cases commenced on or after October 17, 2005, unless otherwise noted. There are at least a half dozen other dates noted including on or after the date of enactment (April 20, 2005) for cases filed after such date. No exceptions apply to the general rule for tax sections.

§ 701. Treatment of certain liens—§724(b)

(a) The trustee may avoid a lien that secures a claim of a kind specified in section 726(a)(4) of this title.
(b) Property in which the estate has an interest and that is subject to a lien that is not avoidable under this title (other than to the extent that there is a properly perfected unavoidable tax lien arising in connection with an ad valorem tax on real or personal property of the estate) and that secures an allowed claim for a tax, or proceeds of such property, shall be distributed--

§ 701. Treatment of certain liens—§724(b)(2)

(1) first, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is senior to such tax lien;
(2) second, to any holder of a claim of a kind specified in section 507(a)(1) (except that such expenses, other than claims for wages, salaries, or commissions that arise after the date of the filing of the petition, shall be limited to expenses incurred under Chapter 7 of this title and shall not include expenses incurred under chapter 11 of this title), 507(a)(2), 507(a)(3), 507(a)(4), 507(a)(5), 507(a)(6), or 507(a)(7) of this title,

§701(b). Determination of tax liability--§505(a)(2)

(a) (1) Except as provided in paragraph (2) of this subsection, the court may determine the amount or legality of any tax. . .
(2) The court may not so determine . . .
(C) the amount or legality of any amount arising in connection with an ad valorem tax on real or personal property of the estate, if the applicable period for contesting or redetermining that amount under any law (other than a bankruptcy law) has expired.
Comment: Courts will no longer be able to redetermine the tax for debtors that did not object to a property tax before the time for such objection expired

§ 703. Notice of request for a Determination of taxes--§505(b)

Bankruptcy court clerk to maintain address list of tax agencies. Alternative if no designation, file where returns filed.

§ 704. Rate of interest on tax claims--§ 511

> ***§ 511. Rate of interest on tax claims***
> (a) If any provision of this title requires the payment of interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law.
> (b) In the case of taxes paid under a confirmed plan under this title, the rate of interest shall be determined as of the calendar month in which the plan is confirmed.

§ 704. Rate of interest on tax claims--§ 511

Nonbankruptcy tax rate is a terrible provision—only example were creditor may receive more than the value of its claim
Federal rate will be close to market
State rate may be much higher than market at a rate greater than 20 percent

§ 705. Priority tax Claims--§ 507(A)

> (8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for--
> (A) a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition--
> (i) for a taxable year ending on or before the date of the filing of the petition for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;
> (ii) assessed within 240 days, plus before the date of the filing of the petition, exclusive of--
> (I) any time plus 30 days during which an offer in compromise with respect to such tax that was made within 240 days after such assessment that tax was pending, before the date of the filing of the petition; or in effect during that 240-day period, plus 30 days; and
> (II) any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days.

§ 706. Priority tax Claims–§ 507(a)(8)(B)

> (B) a property tax assessed incurred before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition;

§ 707. No Discharge of Fraudulent Taxes in Chapter 13—§ 1328(a)(2)

Chapter 13 "super-discharge" now conforms to chapter 7 discharge for individual debtors for purposes of so-called fraud taxes. Tax claims under section 523(a)(1) are now excepted from the chapter 13 discharge. Such claims include priority tax claims, claims associated with fraudulent returns, unfiled returns, and willful attempts to evade or defeat a tax.

§ 708. No Discharge of Fraudulent Taxes in Chapter 11—§ 1141(d)

Section 1141 defines the effect of confirmation of a Chapter 11 plan and specifically discharges certain debts that arose before confirmation. The amendment excepts tax liabilities from a Chapter 11 discharge if the debtor corporation made a fraudulent return or willfully attempted in any manner to evade or defeat that tax or duty. The new provision also excepts from discharge any debt incurred under false pretenses or by making a false statement in writing.

§ 709. Stay of tax proceedings limited to Prepetition taxes—§ 362(a)(8)

New provision states that a petition . . . operates as a stay, applicable to all entities, of—
8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor a corporate debtor's tax liability for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title.

§ 710 Periodic payments of taxes in chapter 11 cases—§ 1129(a)(9)

> (C) with respect to a claim of a kind specified in section 507(a)(8) of this title, the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, regular installment payments in cash--
> (i) of a total value, as of the effective date of the plan, equal to the allowed amount of such claim;
> (ii) over a period ending not later than 5 years after the date of the order for relief under section 301, 302, or 303; and
> (iii) in a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan (other than cash payments made to a class of creditors under section 1122(b) [convenience class]); and

§ 710 Periodic payments of taxes in chapter 11 cases—§ 1129(a)(9)

> (D) with respect to a secured claim which would otherwise meet the description of an unsecured claim of a governmental unit under section 507(a)(8), but for the secured status of that claim, the holder of that claim will receive on account of the claim, cash payments in the same manner and over the same period, as prescribed in subparagraph (C).

§ 711. Avoidance of statutory tax liens prohibited—§ 545(2)

> The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien—
>
> (2) is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists, except in any case in which a purchaser is a purchaser described in section 6323 of the Internal Revenue Code of 1986, or in any other similar provision of State or local law;

§ 712. Payment of Taxes in the Conduct of Business—§ 503

Any governmental entity can now be allowed administrative expense treatment without being required to file an application for allowance and for payment. Under prior law, an application for allowance and payment of an administrative expense was required to be filed before being allowed administrative tax treatment. Section 960, Title 28 makes officials, including the bankruptcy trustee, operating a business under the authority of a United States Court subject to all federal, state and local taxes applicable to such a business. The amendments add two new paragraphs to section 960 to clarify a trustee's duties regarding taxes:

> requires timely payment under nonbankruptcy law unless secured by a lien and abandoned within a reasonable period of time, or otherwise excused under a specific provision of Title 11.
>
> permits deferral of payment until a final distribution if a trustee under Chapter 7 did not incur the tax or if the court makes determination of "probable insufficiency of funds to pay in full all administrative expenses having an equal priority with the tax liability.

This amendment makes two additional changes in aid of state and local taxing authorities. The first change allows any expense authorized by "state statue", under which the claim arose, to be paid when the amount realized exceeds the amount of the secured claim. For example, if the state statute allowed attorney's fees or penalties for failure to pay the amendment would permit payment of those amounts to the extent not considered a part of the secured claim. The second change allows the trustee to recover property taxes from the sale proceeds as a necessary part of maintaining the property.

§ 713. Tardily Filed Priority Tax Claims—§ 724

Prior to amendment, §726 stated that a tardily filed claim, for the purposes of distribution, had to be filed before the date on which the trustee "commenced distribution" under §726. The amendment adds a second condition, namely before the date that is ten days after the mailing to creditors of the summary of the trustee's final report. The first condition was modified by adding, "commences *final* distribution."
Without the change, "any distribution" operated as a bar date for the filing of a tardily filed claim. As amended, that bar date has been moved to the earlier of the trustee's final report or the commencement of "final" distributions.

§ 714. Income tax returns prepared by tax authorities—§ 523(a)

26 USC 6020(a) returns will qualify for discharge (cooperation & signing). 26 USC 6020(b) returns will not qualify for discharge. This provision applies to federal, state and local returns. Return, written stipulation to a judgment or a final order by a nonbankruptcy tribunal.

§ 715 Discharge of the estate's tax liability for unpaid taxes—§505(b)

60/180 day prompt determination request. The estate is now a listed party for relief with a prompt determination.

§ 716. Requirement to file tax returns to confirm chapter 13 plans—§1325(a)

Returns now required for plan confirmation – New Sec. 1308. File prepetition tax returns for past 4 years. Time limit – Section 341 hearing date or up to 120 days if extended. Failure to comply – dismissal or conversion – Section 1307. Includes Section. 6020(a) and (b) returns. Governmental unit gets 60 days after returns filed to object to plan.

§ 717. Standards for Tax Disclosures—§1125(a)

(1) "adequate information" means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable including a discussion of the potential Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical reasonable investor typical of the holders of claims or interests in the case, that would enable such hypothetical investor of the relevant class to make an informed judgment about the plan. But adequate information need not include such information about any other possible or proposed plan and in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information;

§ 718. Setoff of Tax Refund

The amendment excepts from the automatic stay the setoff of a refund and a liability, both of which have their origin in a prepetition taxable period unless the liability is disputed. If either the refund or the liability falls in the postpetition period, the setoff is stayed. If a setoff is tolled during a hearing to determine amount or legality of the tax, then the taxing authority may freeze the refund. This amendment reflects a procedure under local rule in existence in a large number of jurisdictions.

§ 719 Special provisions related to the treatment of state and local taxes

- <u>State and local taxes now follow Internal Revenue code of 1986</u>
- <u>Separate federal taxable entity</u>
- Trustee to make returns for corporations and partnerships.

- Estate liable for tax imposed on corporation or partnership.
- Entity treated as a debtor partnership - income, deduction, or credit taxed to partner or member.
- Taxable period
- Accounting method
- Transfer of property from the debtor to the estate
- Transfer of property from estate to debtor
- State and local taxes now follow Internal Revenue code of 1986
- State or local law tax rates – use rates applicable to same types of entities under State or local law.
- Trustee must withhold and deposit on payment of wage claims.
- Estate succeeds to State and local tax attributes.
- Unused tax attributes returned to the debtor on closing of case.
- Estate may carry back loss or tax attribute if State or local law permits carryback.
- COD excluded from income.
- Reduction of tax attributes for COD – same as federal plus allow for other reductions
- Time of filing tax returns – look to nonbankruptcy law.

§ 720. Dismissal for Failure to Timely File Tax Returns

The debtor must now timely file ***postpetition*** tax returns or suffer conversion or dismissal of the case. The conversion or dismissal is mandatory if the debtor does not file the returns or obtain an extension within ninety days after the taxing authority files its request. This provision applies in Chapter 7, 11, 12, and 13.