

# Part Seven: Tax Aspects of Asset Liquidation, Bankruptcy, and Discharge of Indebtedness

## I. A rational approach to loan review and liquidation

- A. Important factors to consider in loan review for structuring or liquidation—
  - 1. To what extent is the loan secured with realistically valued collateral?
  - 2. Is the loan documentation adequate or would the documentation be vulnerable to challenges by a trustee in bankruptcy?
  - 3. Could the borrower be made financially and economically healthy with a restructuring of the loan and, if so, at what cost to the lender?
  - 4. If restructuring appears feasible overall, how willing are other lenders to absorb an equitable share of the total cost of restructuring?
  - 5. Is the borrower-lender relationship flawed in terms of conflict of interest or other potential challenges?
  - 6. Should a significant weight be attached to avoidance of principal reduction or reduction of interest rate in the interests of “maintaining borrower discipline”?
- B. It is generally not rational to liquidate a loan if the loss expected to be taken is greater than what would be required to keep the borrower in business by restructuring the loan.
  - 1. That determination necessarily involves—
    - a. Probable net recovery on collateral in the event of liquidation.
    - b. The extent to which the lender is unsecured and the probability of recovery as an unsecured creditor after payment of income and other taxes and administrative costs in bankruptcy or other mode of liquidation.
    - c. The economic cost to the lender of interruption of interest payments in the event of liquidation.
    - d. The probability that the borrower, after restructuring, will be able to service the resulting debt.
  - 2. A comparison of outcomes (restructuring and liquidation) on a net present value basis provides guidance as to the most rational approach for the lender.

## II. Information needed for planning

Information needed to make decisions on the income tax consequences of bankruptcy options or the various nonbankruptcy choices (foreclosure, forfeiture, UCC default proceedings, voluntary conveyance to creditors or composition).

- A. **Inventory of all assets of the debtor.** An inventory should be prepared of all assets of the debtor (with exempt assets categorized separately) showing—
1. Original cost or original basis otherwise if received by gift or inheritance.
  2. Depreciation or cost recovery allowed or allowable, depletion taken or amortization deductions claimed.
  3. Fair market value.
  4. Any potential special use valuation recapture under I.R.C. § 2032A and under I.R.C. § 2057 (family-owned business deduction).
  5. Any potential for acceleration of federal estate tax under installment payment provisions pursuant to I.R.C. § 6166 (15 year).
  6. Depreciation recapture potential under I.R.C. § 1245.
  7. Depreciation recapture potential under I.R.C. § 1250.
  8. Potential recapture of soil and water conservation expense on land held less than 10 years under I.R.C. § 175.
  9. Government cost sharing payments excluded from income within the past 20 years under I.R.C. § 126.
  10. Potential for disallowance of a deduction for the expense of producing an unharvested crop “sold” by the taxpayer with the land under I.R.C. § 268.
  11. Status of the asset as likely to produce ordinary income or loss, Section 1231 gain or loss or capital gain or loss. No one test is determinative of the question of whether property is used in the trade or business (§ 1231 property) or as a capital asset (§ 1221 property).
    - a. The test most frequently relied upon is the “active v. passive” test which emphasizes the extent of the taxpayer’s activities in relation to the property. See *Ltr. Rul. 8350008, August 23, 1983* (mere rental of real property does not constitute a trade or business under I.R.C. § 1231).
    - b. A “facts and circumstances” test has been applied by the Tax Court. See *John E. Good, 16 T.C. 906 (1952), acq., 1951-2 C.B. 2* (unimproved land rented for pasture used in trade or business because of consistent attempts by taxpayer to rent land). But see *Durbin v. Birmingham, 92 F. Supp. 938 (S.D. Iowa 1950)* (unimproved land rented to sharecroppers was capital asset where there was no management or control by taxpayer). Compare *Susan P. Emery, 17 T.C. 308 (1951)* (loss from sale of unimproved realty was capital loss); *Ltr. Rul. 8814034, January 11, 1988* (sale of land at loss after Christmas trees died; business had not begun to function). Cf. *Edwin R. Curphey, 73 T.C. 766 (1980)* (ownership and rental of real property does not, as matter of law, constitute trade or business).
    - c. For improved real property, the courts have been more likely to find trade or business status. *Irving Stratton, T.C. Memo. 1962-218; Charles M. Spindler, T.C. Memo. 1963-202*. But see *Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954)* (single family house rented by taxpayer was not property used in trade or business and did not qualify for ordinary loss treatment).
    - d. Even though an asset is connected with a trade or business, it may not have been acquired for use in the trade or business. *Azar Nut Co., 94 T.C. 455 (1990) aff’d, 931 F.2d 314 (5<sup>th</sup> Cir. 1991)* (loss on house acquired from fired executive).
    - e. If property is used in a trade or business and is subsequently rented under a passive arrangement, trade or business status may continue for a period of time. See, e.g., *Wofac Corp. v. United States,*

269 F. Supp. 654 (D. N.J. 1976) (business discontinued because of unprofitability; noncapital asset status not lost immediately).

- f. A loss may not be deductible if the loss relates to a personal asset or the property was not acquired with a profit motive. *Kenneth Ralph Barger, T.C. Memo. 1990-238* (nominal rent paid by son and family to occupy house purchased by taxpayer).
- B. Appraisal of all assets of the debtor.** An appraisal of assets is necessary to determine the fair market value of assets at the time of discharge of indebtedness to determine solvency or insolvency and for the transfer of assets in satisfaction of a debt obligation, the nature of the gain, and, in some instances, to determine application of the exemption rules.
- C. List of creditors and indebtedness for which the taxpayer is obligated.** The list of creditors and indebtedness should be broken down by secured and unsecured debt, recourse debt and nonrecourse debt and should show a breakdown of principal and interest owed.
1. Remember that no income is realized and tax attributes will not be reduced to the extent that payment of a liability would have given rise to an income tax deduction (unless already allowed as a deduction such as by accrual basis taxpayer). *I.R.C. § 108(e)(2)*.
  2. Losses between related parties are disallowed. *I.R.C. § 267*. See *Meek v. Commissioner, 98-1 U.S.T.C. ¶ 50,179 (9<sup>th</sup> Cir. 1998)* (capital loss deduction denied for sale of limited partnership to trust for children; related party transaction under *I.R.C. § 267*).
- D. List of the taxpayer's attributes.** It is necessary to ascertain the amount of the taxpayer's net operating loss carryover, net capital loss carryovers and tax credit carryovers. The taxpayer's tax attributes are important in determining whether property should be transferred outside of bankruptcy in satisfaction of indebtedness or the taxpayer should file for bankruptcy. Tax attributes must be reduced to the extent of discharged indebtedness (unless the taxpayer is eligible to and does elect to reduce the basis of certain depreciable property in lieu of a reduction of tax attributes) with different rules for taxpayers who are solvent, insolvent or in bankruptcy.
- E. Calculation of income tax liability under various alternatives.** A complete calculation of state and federal income tax liability under the various asset liquidation and bankruptcy choices is highly advisable before decisions are made on alternative liquidation/bankruptcy routes. The calculation should include the various recapture possibilities. Moreover, the calculation should show who bears the burden of tax liability under the various options. The matter of who bears the tax burden can be highly important, for example, in the case of unsecured creditors in bankruptcy and may represent one of the more potent weapons to encourage creditor acceptance of a plan. The matter of who bears the tax burden is also highly important to the debtor from the standpoint of tax liability remaining with the debtor after property transfers have been concluded.

### III. Payment of debt with property

- A. Recourse debt**
1. If property is sold for cash and the cash is applied on the debt, the taxpayer has—
    - a. Asset gain or loss from the transfer of the property, measured by the difference between the adjusted income tax basis of the transferred property and the amount received for the property, and would be taxed in accordance with the usual gain-on-sale rules, and
    - b. Gain or loss from payment of the debt, which is measured by the difference between the unpaid balance of the debt and the amount paid toward discharging the debt, and would be taxed under the usual discharge of indebtedness rules.
  2. If debt relief obtained by the transfer of property is to be taxed in the same manner as debt relief secured

by payment of cash, the same two-step procedure should apply. That is, the taxpayer would have—

- a. Asset gain or loss from the transfer of the property, measured by the difference between the adjusted income tax basis of the property and the fair market value of the property, and
- b. Gain or loss from payment of the debt measured by the difference between the unpaid balance of the debt and the fair market value of the property.
  - (1) If the fair market value of the transferred property is less than the unpaid balance of the debt, the unsatisfied portion of the debt would produce cancellation of indebtedness income to the debtor and a bad debt deduction to the creditor. See *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). See *Treas. Reg. § 1.166-6(a)* (foreclosure). See also *Rev. Rul. 68-523, 1968-2 C.B. 82 (voluntary reconveyance)*.
  - (2) If the fair market value of the property exceeds the unpaid balance of the debt, the excess is taxable to the creditor. See *Rev. Rul. 68-523, 1968-2 C.B. 82* (amount by which value of property received in involuntary conveyance exceeds creditor's basis is includible in creditor's gross income).

### Example

A taxpayer in 1987 transferred to a creditor an asset with a fair market value of \$60,000 and the creditor discharged \$75,000 of indebtedness for which the taxpayer is personally liable. The taxpayer's income tax basis in the asset is \$40,000. The \$40,000 return of basis would be without income tax consequences. The difference between basis and fair market value of the property (\$20,000) would be taxed as though the property were sold and may produce ordinary income or capital gain depending upon the nature of the asset involved. Transfer of the asset to a creditor may also produce various recapture consequences (depreciation, investment tax credit, soil and water conservation expense, land clearing expense, government cost sharing payments, deductions for unharvested crop). Finally, the taxpayer would have income from the discharge of indebtedness of the difference between the fair market value of the property and the amount of indebtedness discharged (\$15,000). See *Treas. Reg. § 1.1001-2(c)*, Example 8. *Rev. Rul. 90-16, 1990-1 C.B. 477*; *Jenniges v. United States*, 90-1 U.S.T.C. ¶ 50,090 (D. Minn. 1990) (conveyance of farm to bank). See *Ltr. Rul. 8735065, June 4, 1987* (two-step transaction applied where parent as guarantor transferred farmland to lender in satisfaction of debt); *Ferris E. Traylor, T.C. Memo. 1990-132* (taxpayer realized capital gain from sale of stock to children and discharge of indebtedness income when children acquired remainder of debtor's obligations). The discharge of indebtedness amount may come under one of the exceptions to the general rule that discharge of indebtedness amounts are income. *Thomas E. Bressi, Jr., T.C. Memo. 1991-651* (capital gains income as to excess of fair market value over basis; discharge of indebtedness income for indebtedness discharged over fair market value).

- (3) The difference between the basis and fair market value (or foreclosure sale price) is gain or loss from disposition of the property. *James J. Gehl*, 102 T.C. 784 (1994), *aff'd*, 95-1 U.S.T.C. ¶ 50,191 (8<sup>th</sup> Cir. 1995) (excess of fair market value of property over basis was gain even for insolvent taxpayer); *J.Y. Aizawa*, 99 T.C. 197 (1992) *aff'd, unpub. mem. dec.* (9<sup>th</sup> Cir. 1994) (unpaid recourse liability survived as part of deficiency judgment); *Richard W. Cox, T.C. Memo. 1994-189* (taxable gain to extent foreclosure sale proceeds exceeded basis in property); *Richard D. Frazier*, 111 T.C. 243 (1998) (amount realized at foreclosure sale was fair market value, not foreclosure sale price, where foreclosure sale price exceeded fair market value; taxpayer realized capital loss on transfer as well as discharge of indebtedness income which was excludible under insolvency exception). See *William Spencer Bach, T.C. Memo. 1998-47, aff'd*, 99-1 U.S.T.C. ¶ 50,550 (4<sup>th</sup> Cir. 1999) (gain on disposition of limited partnership interests in the amount of liabilities for which taxpayers were relieved); *Michael Correra, T.C. Memo. 1997-356* (capital gain realized could not be excluded as discharge of indebtedness income). See also *Jerry Meyers Johnson, T.C. Memo. 1999-162, aff'd*, 00-1 U.S.T.C. ¶ 50,391

(4<sup>th</sup> Cir. 2000) (debt discharge income on foreclosure of residence included in gross income; accrued interest not discharge of indebtedness income); *Thomas Louis Mitchell, T.C. Memo. 1997-382* (foreclosure of partnership interest produced capital loss); *Shirley Deon Emmons, T.C. Memo. 1998-173* (taxpayer held to have realized capital gain to extent mortgage indebtedness of which taxpayer was relieved exceeded basis; no mention of discharge of indebtedness); *Donna M. Neighbors, T.C. Memo. 1998-263* (sale of residence without replacement after debt discharge in bankruptcy).

- (4) An individual debt realizes discharge of indebtedness income upon the discounted prepayment to a lender of all or a portion of indebtedness whether recourse or nonrecourse. *Rev. Rul. 82-202, 1982-2 C.B. 36*. See *Rev. Rul. 91-31, 1991-1 C.B. 566* (reduction of principal amount of undersecured nonrecourse debt by holder of debt who was not seller of property securing debt results in discharge of indebtedness income).
  - (5) There is no relief if property is sold and the proceeds are used to pay down the debt. In re *Paul T. Dobbs, 98-1 U.S.T.C. ¶ 50,359 (E.D. Mich. [Bkrpcy.] 1998)* (sale of residence without purchase of replacement (pre-May 7, 1997, transaction) triggered gain).
  - (6) The release of an obligor and the assumption of the obligation by the guarantor may not be a taxable exchange under Treas. Reg. § 1.1001-3. *Ltr. Rul. 9904017, Oct. 29, 1998* (payment expectations of note holder based primarily on credit of guarantor). See *Joel Friedland, T.C. Memo. 2001-236* (father's transfer of pledged stock to bank in satisfaction of son's loan and in forgiveness of son's guaranty on loan; discharged debt was not debt of transferor so no gain realized).
  - (7) The transfer of property to a corporation may produce a dividend and capital gain income under discharge of indebtedness rules. *Burke v. Commissioner, 99-1 U.S.T.C. ¶ 50,512 (10<sup>th</sup> Cir. 1999)*.
  - (8) Legislation has been introduced to exclude from income up to \$350,000 of gain from the transfer of farm property in satisfaction of indebtedness. *S. 1861, 106<sup>th</sup> Cong., 1<sup>st</sup> Sess. (1999)*.
3. The treatment of gain on conveyance of property to creditors in satisfaction of debt has not always been clear-cut and consistent. The Internal Revenue Service sometimes has treated the discharge of recourse debt through the transfer of property to a creditor as gain or loss from the sale of property, measured by the difference between the amount of debt discharged and the adjusted income tax basis of the property transferred. See *Rev. Rul. 73-36, 1973-1 C.B. 372* (capital loss measured by difference between basis and amount of cancelled obligation).
- a. The courts have sometimes agreed, holding that a transfer of property in discharge of debt results in gain from sale rather than in cancellation of indebtedness income. See *R. O'Dell & Sons, Inc., 8 T.C. 1165 (1947), aff'd, 169 F.2d 247 (3d Cir. 1948)*; *Carlisle Packing Co., 29 B.T.A. 514 (1933)*. See also *Charles F. Nutter, 7 T. C. 480 (1946), acq., 1946-2 C.B. 4* (no loss allowed).
  - b. That result has been reached regardless of whether the property transferred was the property securing the debt or other property and regardless of whether the transfer occurred by means of a foreclosure or a voluntary reconveyance. Thus, gain results to the extent the liability discharged exceeds the adjusted income tax basis of the property.
  - c. Other courts treated the transaction as producing cancellation of indebtedness income rather than all being gain or loss from sale. *E.g., Julian S. Danenberg, 73 T.C. 370 (1979), acq., 1980-2 C.B. 3*. The transaction is treated as if the transferor had sold the asset for cash equivalent to the amount of the debt and applied the cash to payment of the debt. *Peninsula Properties Co., 47 B.T.A. 84 (1942), acq., 1942-2 C.B. 14*. Where that was the outcome, the cancellation of indebtedness income was measured by the difference between the fair market value of the transferred property and the liability discharged. This is believed to be the correct result. IRS

seems to agree. *Ltr. Rul. 8614022, January 2, 1986* (in exchange of property for release of debt exceeding fair market value of property, taxpayer realized capital gain or loss on difference between fair market value and adjusted basis of property transferred and discharge of indebtedness income to extent debt exceeded fair market value of property transferred). See *Vukasovich, Inc. v. Commissioner, 790 F.2d 1409 (9<sup>th</sup> Cir. 1986)*.

- (1) In *Texas Gas Distributing Co., 3 T.C. 57 (1944)*, the court held that the taxpayer realized gain on the sale of assets in exchange for assumption of liabilities, discharge of debt and cash only to the extent of the cash received. The IRS has announced its nonacquiescence in the decision in that IRS believes gain should have been recognized to the extent of the difference between the taxpayer's basis in the property sold and the property's fair market value. *1987-1 C.B. 1*.
- d. In *Commissioner v. Tufts, 461 U.S. 300 (1983)*, the United States Supreme Court held that the amount realized on the disposition of the property was equal to the unpaid balance of the debt and that there was no cancellation of indebtedness income. *Tufts* involved nonrecourse debt but the court did not limit the holding to nonrecourse debt.
  - (1) *Tufts* involved a determination of the amount realized from the sale of debt-encumbered property having a value substantially less than the nonrecourse encumbrance. The taxpayers were partners in a partnership which financed the construction of an apartment complex with a nonrecourse loan. After the rental market slumped, the partners sold their interests to a third party, subject to the debt, for a total of \$250 in cash. The taxpayers in calculating the amount realized included their shares of the debt only to the extent of the fair market value of the transferred property, which produced a loss. IRS treated the amount realized as including the full recourse debt, resulting in a gain.
  - (2) The court in *Tufts* expressly declined to apply the two step analysis discussed above.
  - (3) The Sixth Circuit Court of Appeals has likewise refused to apply the two-step analysis in a mortgage foreclosure where the debtors were personally liable on the obligation. *Chilingirian v. Commissioner, 918 F.2d 1257 (6<sup>th</sup> Cir. 1990)*.

## B. Nonrecourse debt

1. The two step analysis discussed above seems equally valid in the case of nonrecourse debt so long as the fair market value of the property exceeds or is equal to the unpaid balance of the debt.
2. If the value of the property is less than the unpaid balance of the debt, the amount realized on the asset portion of the transaction must be calculated by reference to the unpaid balance of the debt rather than by reference to the fair market value of the property. See *Commissioner v. Tufts, 461 U.S. 300 (1983)*; *Estate of Newman, T.C. Memo. 1990-230*. See *Rev. Rul. 82-202, 1982-2 C.B. 36*; *Ltr. Rul. 9302001, August 31, 1992* (difference between property basis and debt is gain; no discharge of indebtedness income). Compare *Fulton Gold Corp., 31 B.T.A. 519 (1934)* (reduction in nonrecourse debt results only in basis reduction, not in immediate taxation).
  - a. The amount realized is the full amount of the nonrecourse liabilities which are discharged as a result of the transfer of the property. *Allan v. Commissioner, 856 F.2d 1169 (8<sup>th</sup> Cir. 1988)*, *aff'g, 86 T.C. 655 (1987)* (advances for interest added to nonrecourse mortgage principal were part of debt obligation); *L&C Springs Associates, Inc. v. Commissioner, 188 F.3d 866 (7<sup>th</sup> Cir. 1999)* (gain triggered when bank took over property and taxpayer relieved of liability); *Clarence Williams, T.C. Memo. 1990-266* (partnership defaulted on nonrecourse mortgage and HUD foreclosed). See *FSA 200135002, April 10, 2001* (debtor's default and sale of encumbered property should be treated as sale or exchange; reduction of debt not taxed separately as discharge of indebtedness).

- b. The debtor realizes no cancellation of indebtedness income. See *2925 Briarpark, Ltd., T.C. Memo. 1997-298, aff'd, 163 F.3d 313 (5<sup>th</sup> Cir. 1999)* (income from discharge of nonrecourse loans treated as gain and not discharge of indebtedness income).
  3. A contract of sale with the remedy limited to forfeiture would be a nonrecourse debt. See *Treas. Reg. § 1.1038-1(d), 1.453-9(a)*.
  4. Commodity loans from the Commodity Credit Corporation are nonrecourse loans to the extent that the debtor may pay off the loan with a sufficient amount of an eligible commodity having a price support value equal to the outstanding value of the loan. *7 C.F.R. § 1421.19(a)*. If insufficient commodity of acceptable quality is transferred, the debtor is still personally liable for any deficiency. *7 C.F.R. § 1421.23(d)*.
  5. Where a creditor has agreed to pay taxes and interest due on a nonrecourse real property mortgage and to add the amounts paid to the principal of the mortgage, the amount realized by the debtor upon transfer of the property to the creditor in satisfaction of the mortgage includes the additional amounts added for taxes and interest, even though the taxpayer claimed the taxes and interest as deductions as they accrued. *J. A. Allan, 86 T.C. 655 (1987), aff'd, 856 F.2d 1169 (8<sup>th</sup> Cir. 1988)*.
  6. A debtor in bankruptcy may encounter non-recourse debt treatment where property subject to recourse debt has been abandoned to the debtor. In *Ltr. Rul. 8918016, January 31, 1989*, real property of a Chapter 7 debtor had been abandoned to the debtor. The unsecured portion of the mortgage was discharged in bankruptcy. The mortgage, however, survived the bankruptcy. IRS ruled that the taxpayer had to reduce income tax attributes by the amount of the mortgage discharged in bankruptcy under I.R.C. § 108, including reduction of basis of the mortgaged property. IRS further ruled that the taxpayer would realize upon foreclosure of the mortgage *the entire remaining secured portion of the mortgage as proceeds of a nonrecourse loan* (the personal liability of the taxpayer having been discharged in bankruptcy) and recognize gain to the extent the remaining mortgage exceeded the taxpayer's basis in the property after reduction for the discharge of indebtedness in bankruptcy. See *Patrick E. Catalano, T.C. Memo. 2000-82* (relief from stay granted on residence, residence sold in foreclosure; income tax consequences same as abandonment with full amount between basis and debt treated as gain for nonrecourse loan).
  7. If the value of property is less than the outstanding nonrecourse debt to which the property is subject, a loss may be allowable. *Treas. Reg. § 1.165-1(d)(1)*. See *Echols v. Commissioner, 935 F.2d 703 (5<sup>th</sup> Cir. 1991), pet. rehear'g denied, 950 F.2d 209 (5<sup>th</sup> Cir. 1991)* (for partnership, loss is allowable when partners abandon interest in partnership).
- C. Special rules for FmHA/FSA debt restructuring
1. In the Agricultural Credit Act of 1987, the Farmers Home Administration (now the Farm Service Agency) and Farm Credit Services were instructed by Congress to avoid losses on loans with priority consideration to writing down the loan principal and interest and setting aside debt whenever those procedures would make it possible for a borrower to survive and remain on the farm or ranch. *Pub. L. No. 100-233, Sec. 615, 101 Stat. 1678 (1988), adding 7 U.S.C. § 2001*.
    - a. To be eligible for restructuring assistance, FmHA loans had to meet several conditions—
      - (1) The delinquency must have been beyond the borrower's control.
      - (2) The borrower must have acted in good faith.
      - (3) The borrower must have presented a preliminary plan with reasonable assumptions indicating that the borrower would be able to meet necessary family living and operating expenses, and service all remaining debt.

- (4) The recovery for FmHA would have been equal to or more than the recovery from foreclosing or liquidating.
  - b. Under the FmHA debt write-down program, a borrower's loans could be written-down to the point that the "net recovery value" of the restructured debt was equal to or greater than the net recovery value of the collateral securing the debt. *See 7 C.F.R. § 1951.909.*
    - (1) A new promissory note was executed for each note rescheduled or reamortized.
    - (2) A borrower must enter into a shared appreciation agreement for all write-downs involving real estate as collateral. *7 C.F.R. § 1951.909(e)(5).*
  - c. Amount recaptured—
    - (1) The agreement called for the borrower to pay 75 percent of any appreciation in fair market value of the collateral if, within four years, the loan was paid off, the borrower ceased farming or the borrower transferred the property.
    - (2) The borrower was to pay 50 percent of any appreciation if the triggering event occurred after four years or, if not, upon termination of the agreement (up to 10 years).
    - (3) The total amount recoverable was capped at the dollar amount of the debt write-down. *7 U.S.C. § 353(e).*
  - d. The amount recaptured is "the difference between the appraised values of the real security property at the time of the restructuring and at the time of recapture." *7 U.S.C. § 353(e)*. *See Viers v. Glickman, 4-99-CV-90431 (S.D. Iowa 2000)* (FSA acted without authority in adjusting original valuation of debtor's property).
2. Many of the shared appreciation agreements have reached the 10 year anniversary of the agreement reached with then FmHA with substantial amounts owing.
    - a. A significant question exists as to the nature of the shared appreciation agreement payment.
      - (1) In a 1983 ruling, IRS allowed a taxpayer on the cash method of accounting to deduct the contingent interest on a shared appreciation mortgage even though the interest was not computed at a fixed rate. *Rev. Rul. 83-5, 1983-1 C.B. 48*. The ruling cautions that the conclusions may not apply to commercial or business loans. The ruling involved contingent interest on a residential mortgage of 40 percent of the appreciation payable when the shared appreciation agreement was terminated.
      - (2) Shortly thereafter, the income tax treatment of shared appreciation mortgages appeared on the "no rulings" list and has continued on that list. *Rev. Proc. 94-3, 1994-1 C.B. 447*.
      - (3) Legislation has been introduced to make "contingent interest on a shared appreciation mortgage" on real property deductible as interest. *H.R. 4637, 105<sup>th</sup> Cong., 2d Sess. (1998)*.
    - b. The IRS position on handling the write-down is discussed in Appendix B.
  3. On November 10, 1999, the Farm Service Agency issued proposed regulations amending the Shared Depreciation Agreement (SAA) and the servicing regulations of SAAs. *64 Fed. Reg. 61221, November 10, 1999*. The regulations have been made final. *65 Fed. Reg. 50,401, August 18, 2000*.
    - a. The amendments allow the "contributory value" of some capital improvements made during the term of the SAA to be deducted from the recapture amount (dwelling, barn, grain storage bin or silo), changed the maturity period of future SAAs from 10 to five years and reduced the interest

rate on SAA loans to the Farm Program Homestead Protection rate (approximately the federal borrowing rate, the same rate as the direct operating loan rate—one point over the 90-day T-bill rate). *7 C.F.R. § 1951.914.*

- b. The interest rate has been reduced by 100 basis points (from the Farm Homestead Protection rate) by the Agricultural Appropriations Act of 2000 and payment of amounts owed over 25 years has been authorized by the same legislation which was signed on October 28, 2000. *Agricultural Appropriations Act, Sec. 818, 106<sup>th</sup> Cong., 2d Sess. (2000).*
  - c. The IRS position is that if a write-down occurs and no shared appreciation agreement is entered into, the write-down by FmHA results in cancellation of indebtedness for federal income tax purposes. *I.R.S. Letter, Appendix B.*
  - d. In those instances in which FmHA requires a shared appreciation agreement, IRS has taken the position that the indebtedness is nonetheless considered discharged for federal income tax purposes to the extent of the write-down. *I.R.S. Letter, Appendix B.* The shared appreciation agreement is not considered a substitute debt and is considered too contingent to preclude discharge of indebtedness from occurring.
4. In the event a feasible debt restructuring plan cannot be worked out with FmHA, a debtor is permitted to purchase the collateral at its net recovery value if the net recovery value of the secured property exceeds the net recovery value of a restructured loan supported by the debtor's cash flow. *7 C.F.R. § 1951.909(h)(3).*
    - a. The debtor is required to execute a recapture agreement and to agree to pay in full the difference between the net recovery value of the property and the fair market value of the property (as of the date of the agreement) if the property is conveyed for an amount greater than the net recovery value.
    - b. The IRS position is that the transaction constitutes a prepayment of the loan with discharge of indebtedness occurring to the extent of the difference between the outstanding loan balance and the buyout amount. *I.R.S. Letter, Appendix B, p. 6.* The IRS position is that the obligation to pay under the recapture agreement is so contingent that it cannot serve as substitute indebtedness for the FmHA debt in excess of the buyout amount. Therefore, a debtor realizes discharge of indebtedness income to the extent the "old" FmHA debt balance exceeds the buyout amount even though a recapture agreement is executed. *Dennis Jelle, 116 T.C. 63 (2001)* (FmHA mortgage buyout at net recovery value produced discharge of indebtedness income; 10-year recapture agreement executed).
  6. In the event a debtor who has entered into a shared appreciation agreement or recapture agreement makes a payment under one of those agreements, the debtor is instructed to reverse the treatment of the discharged debt. Thus, the first dollar of payment is treated as repayment of the last dollar of debt discharged. That process may result in an income tax deduction (for discharge of indebtedness that had been reported into income), restoration of tax attributes (to the extent tax attributes had been reduced) and restoration of basis (to the extent basis had been reduced). To the extent indebtedness was discharged with no adjustment to income, tax attributes or basis, reversal of the process produces no modification in gain, loss or basis for the debtor. If the property had been disposed of, the debtor is entitled to a corresponding adjustment in the form of deduction or loss.
  7. The Farm Service Agency (FSA) has announced in interim regulations amending the shared appreciation agreement requirements that borrowers with SAAs ending in 1999 and 2000 who have not paid their obligation or made arrangements to pay and cannot now pay the amount owed are allowed to have all or part of the obligation suspended for one year. *64 Fed. Reg. 19,863, April 23, 1999.* If USDA determines that the borrower still cannot pay after one year, the suspension may be renewed not more than twice. During the suspension period, the obligation accrues interest at the federal borrowing rate. Apparently, the suspension does not affect the calculation (does not change the date for calculating property values, for example).

## D. Examples believed to represent proper income tax treatment—

## 1. Recourse obligation

**Example 1**

M purchased an unimproved farm in 1981 for use in M's farm business for \$200,000 on contract (which was a recourse obligation). In 1985, M forfeited the contract to the seller at a time when the amount due on the contract was \$160,000 and the fair market value of the farm was \$120,000. M was insolvent at the time. M would have an \$80,000 Section 1231 loss ( $\$200,000 - \$120,000$ ). M would have \$40,000 of discharge indebtedness income to be handled under rules applicable to such income.

## 2. Nonrecourse obligation

**Example 2**

M purchased an unimproved farm in 1981 for use in M's farm business for \$200,000 on contract (which was a nonrecourse obligation). In 1985 M forfeited the contract to the seller at a time when the amount due on the contract was \$160,000 and the fair market value of the farm was \$120,000. M was solvent at the time. M would have a \$40,000 Section 1231 loss. The fair market value of the property is not relevant. The gain or loss is determined by comparing the difference between the income tax basis of the defaulting purchaser and the liability discharged.

## 3. Recourse and nonrecourse obligation

**Example 3**

H purchased from D an unimproved tract of land in 1981 for \$64,000 on contract requiring 20 percent down with the balance to be paid at 10 percent per year for 20 years. In 1985, the property was voluntarily reconveyed to D in exchange for cancellation of the remaining balance due on the contract, \$47,250. At the time of the reconveyance, the property had a fair market value of \$32,000 and an income tax basis to H of \$16,600. If the obligation was nonrecourse, H would realize \$30,650 ( $\$47,250 - \$16,600$ ) of gain from the transfer. If the obligation is recourse, H has \$15,250 ( $\$47,250 - \$32,000$ ) of discharge of indebtedness income and \$15,400 ( $\$32,000 - \$16,600$ ) of gain on the transfer.

## 4. Tax consequences of disposition of obligation

**Example 4**

In 1983, C purchased an asset for \$100,000. C paid the seller \$10,000 in cash and signed a note payable to the seller for \$90,000. C was personally liable on the obligation. During 1983 and 1984, C claimed depreciation of \$31,000 and reduced the principal balance to \$76,000. C sold the asset at the beginning of 1985. The buyer, D, paid \$16,000 in cash and assumed the \$76,000 outstanding liability. C's amount realized is \$92,000 ( $\$16,000 + \$76,000$ ). C's adjusted basis was \$69,000 ( $\$100,000 - \$31,000$ ) so the gain recognized is \$23,000 ( $\$92,000 - \$69,000$ ).

## E. Tax consequences of defaulting purchasers

## 1. Debtors who give up an equity interest in property acquired for the production of income, for investment or for use in the business may have a deductible loss.

a. The loss includes the original investment plus any other payments made (including any deficiency payments).

b. The loss is available whether the property was given up through foreclosure, forfeiture or voluntary transfer.

2. Type of loss
  - a. For capital assets, the taxpayer has a capital loss.
  - b. If the property was used in the business, a net loss would be ordinary.
  - c. A loss on the residence, and losses on other personal assets, would not be deductible.
3. If property is used partly for business and partly for personal use, the loss deduction is limited to the percentage used for business purposes. Thus, a loss on the business portion of an automobile or the business office portion of the residence would be deductible.

#### IV. Discharge of indebtedness

- A. In general, if indebtedness is cancelled or forgiven, the amount cancelled or forgiven must be included in gross income. *I.R.C. § 61(a)(12)*. See *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409 (9<sup>th</sup> Cir. 1986), *aff'g in part and rev'g in part*, T.C. Memo. 1984-611 (cancellation of indebtedness for less than amount owed resulted in ordinary income to debtor); *Rood v. Commissioner*, 97-2 U.S.T.C. ¶ 50,619 (11<sup>th</sup> Cir. 1997) (debt discharge income realized upon cancellation of gambling debt by casino); *Joseph P. Schneller*, T.C. Memo. 1996-62 *aff'd*, 97-2 U.S.T.C. ¶ 50,956 (6<sup>th</sup> Cir. 1997) (discharge of indebtedness from write off of shareholder loans); *Johnson v. Commissioner*, 00-1 U.S.T.C. ¶ 50,391 (4<sup>th</sup> Cir. 2000) (taxpayer liable for tax on discharge of indebtedness income on foreclosure of residence; not eligible for I.R.C. § 108 exclusion); *John Michaels*, 86 T.C. 1412 (1986) (discount on mortgage on residence received in return for prepayment was income from discharge of indebtedness not eligible for deferment of gain upon purchase of new residence; income was taxable as ordinary income); *Sutphin v. United States*, 14 Cls. Ct. 545 (Cls. Ct. 1988) (discount on mortgage on residence received in return for prepayment was income from discharge of indebtedness where value of residence not less than full mortgage amount); *Milton H. Juister*, T.C. Memo. 1987-292 (same); *United States Steel Corp. v. United States*, 848 F.2d 1242 (Fed. Cir. 1988), *rev'g and rem'g*, 11 Cls. Ct. 375, 11 Cls. Ct. 375 and 11 Clst. Ct. 541, 11 Cls. Ct. 541 (Cls. Ct. 1987) (corporation did not realize income from discharge of indebtedness where corporation repurchased for \$118.13 debentures with face value of \$175 which had been exchanged for preferred stock with par value of \$100; purchase of debentures did not increase corporation's assets); *John D. Schrott*, T.C. Memo. 1989-346 (fraudulent pyramid-type scheme); *Hirotohi Yamamoto*, T.C. Memo. 1990-549 (exchange of worthless promissory note for taxpayer's debt resulted in discharge of indebtedness income); *A. C. Marcaccio*, T.C. Memo. 1995-174 (discharge of indebtedness income as to difference between settlement amount and amount of loans for general partner under personal guarantee of partnership loans); "duty of consistency" doctrine prevented shareholders from claiming written-off amounts were loans); *Datha D. Burke*, T.C. Memo. 1997-237, *aff'd*, 99-1 U.S.T.C. ¶ 50,512 (10<sup>th</sup> Cir. 1999) (cancellation of debt to wholly-owned corporation produced dividend to extent debt exceeded value of properties transferred to corporation). Compare *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990) (no discharge of indebtedness income from gambling where debt unenforceable under state law); *Ronald H. Bradshaw*, T.C. Memo. 1996-123 (no discharge of indebtedness from check-kiting scheme); *Layne E. Preslar*, T.C. Memo. 1996-543 *rev'd*, 167 F.3d 1323 (10<sup>th</sup> Cir. 1999) (discharge of indebtedness where negotiations with FDIC involved liability owed insolvent bank); *Richard Leo Warbus*, 110 T.C. 279 (1998) (debt discharge income realized by American Indian from Bureau of Indian Affairs forgiveness of loan not exempt fishing rights income); *Cleo Perfume, Inc.*, T.C. Memo. 1998-155 (no discharge of indebtedness income on product received from supplier on consignment and not sold).
  1. Cancellation of accrued interest (unless deducted by a taxpayer on the accrual method of accounting) is of no income tax consequence since the receipt of interest income is offset by a deduction of interest expense.
  2. Forgiveness of principal balances does have income tax consequences and may involve—
    - a. The equivalent of a sale up to the fair market value of the property, or

- b. Cancellation of indebtedness.
    - (1) I.R.C. § 108 providing relief for discharge of indebtedness does not apply to gain realized on transfer of property. *Ltr. Rul. 9120010, February 14, 1991*. See *Gehl v. Commissioner, 95-1 U.S.T.C. ¶ 50,191 (8<sup>th</sup> Cir. 1995)*.
    - (2) In general, cancellation of indebtedness rules apply to amounts above the fair market value of property up to the total amount of indebtedness discharged. This problem area is discussed in greater detail below.
3. Discharge of indebtedness occurs—
- a. If no objections to discharge are sustained, in Chapter 7 bankruptcy 60 days after the meeting of creditors at which the debtor appears and is examined under oath. *Bkrpcy. Rule 4004(a), (c)*.
  - b. Under Chapter 11 bankruptcy upon confirmation of a plan of reorganization as to debts arising before confirmation with some exceptions. *11 U.S.C. § 1141*.
  - c. Under Chapter 12 bankruptcy “as soon as practicable” after completion of payments under the plan. *11 U.S.C. § 1228(a)*.
  - d. For Chapter 13 bankruptcy, upon completion of payments under the plan. *11 U.S.C. § 1328(a)*.
  - e. In a foreclosure action, discharge of indebtedness occurs when all appeals of the action have been exhausted. See *Thomas A. Ryan, T.C. Memo. 1988-12, aff’d, 873 F.2d 194 (8<sup>th</sup> Cir. 1989)* (accrual basis limited partners realized income from discharge of indebtedness in taxable year appeal of foreclosure action completed and not year of foreclosure sale).
  - f. In the cancellation of a loan in exchange for a cash payment, discharge occurs in the year the costs are paid. *Shannon v. Commissioner, T.C. Memo. 1993-554*. See *Benjamin Rivera, T.C. Memo. 1993-609* (cancelled indebtedness was income in year settlement agreement executed and payments made, not in following year when recorded).
  - g. In general, there must be an identifying event or forgiveness on the part of creditors to give rise to discharge of indebtedness income. *Michael Friedman, T.C. Memo. 1998-196* (filing of involuntary bankruptcy petition not sufficient).
4. One exception to recognition of discharge of indebtedness as taxable income is where the discharge is intended as a gift. *Helvering v. American Dental Co., 318 U.S. 322 (1943)*. See *Commissioner v. Jacobson, 336 U.S. 28 (1949)* (repurchase by maker of secured negotiable bonds issued at face value for less than face amount did not involve gift). See also *DiLaura v. Commissioner, T.C. Memo. 1987-291* (no evidence gift intended on discharge of indebtedness); *Loretta Jean Randolph, T.C. Memo. 2000-248* (corporate shareholder realized discharge of indebtedness income in connection with corporate cancellation of promissory note; not gift; statute of limitations had run on family note transaction).
5. Apparently, income from discharge of indebtedness is subject to self-employment tax if related to the operation of a trade or business or a trade or business investment in which the taxpayer materially participates. See *Rev. Rul. 76-500, 1976-2 C.B. 254* (cancellation of part of FmHA emergency loan). See also *Farmer’s Tax Guide, Pub. 225 (Rev. Oct. 1989), p. 42*.
6. Debt forgiveness income is passive activity gross income to the extent that the forgiven loan is traceable to a passive activity under the interest allocation rules. *Rev. Rul. 92-92, 1992-2 C.B. 103*.
7. The filing of a joint return does not make one spouse liable for the other spouse’s discharge of indebtedness income if the debtor spouse’s assets exceed liabilities after the discharge. *Deanna M.*

*Traci, T.C. Memo. 1992-708.*

## B. Exceptions to general rule

### 1. Debtors in bankruptcy

- a. Indebtedness cancelled as a result of bankruptcy is not included in the debtor's income. *I.R.C. § 108(a)(1)(A)*. See *Ltr. Rul. 8928012, April 7, 1989* (Chapter 12 debtor was "in bankruptcy" for purposes of discharge of indebtedness). Rather, the cancelled indebtedness leads to reduction in the income tax basis of the debtor's property or other "tax attributes" are reduced or both. *Lewis v. Commissioner, T.C. Memo. 1989-78, aff'd Unpub. Op. (6<sup>th</sup> Cir. 3/14/91)* (discharge of indebtedness from foreclosure on farm property in Chapter 11 bankruptcy as result of post-bankruptcy agreement with mortgagee). The result is a postponement of income tax liability on cancellation of indebtedness until the property is sold or the reduced tax attributes could have been used.
  - (1) It is not important for income tax purposes whether the taxpayer is solvent or insolvent. Note that bankruptcy proceedings under Title 11 of the U. S. Code can apply to both solvent and insolvent taxpayers if the bankruptcy court has jurisdiction.
  - (2) A bankruptcy case under Title 11 of the U. S. Code meets the tax definition of bankruptcy "only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court". *I.R.C. § 108(d)(2)*. Thus, receivership, foreclosure and UCC default proceedings do not qualify nor do forfeitures come within the definition.
  - (3) Because there is no income to the taxpayer from the discharge of indebtedness in bankruptcy, the taxpayer may not claim any loss from the sale of property for less than basis. See *William C. Lewis, T.C. Memo. 1989-78, aff'd, Unpub. Op. (6<sup>th</sup> Cir. 3/14/91)* (loss disallowed from foreclosure sale of property for less than taxpayer's basis where taxpayer had discharge of indebtedness income in bankruptcy).
- b. Some taxes as debts of the bankruptcy estate are not dischargeable. See *11 U.S.C. § 523(a)*. Those include—
  - (1) Taxes which are an eighth priority claim in the bankruptcy estate. Income taxes including penalties, for taxable years ending on or before the date of filing the bankruptcy petition and requiring returns to be filed within three years of the filing of the petition are eighth priority claims. *11 U.S.C. § 507(a)(7)(A)*. The bankruptcy estate's liability for recapture of investment tax credit claimed by the debtor before commencement of the case is also an eighth priority claim. *11 U.S.C. § 507(c)*. The debtor's federal income tax liability for the first short year (if any election is made to terminate the debtor's taxable year as of the day before the date of bankruptcy filing) is an allowable eighth priority claim against the bankruptcy estate. See *S. Rep. No. 96-1035, 96<sup>th</sup> Cong., 2d Sess. 26 (1980)*.
  - (2) Taxes for which a return was required but not filed or was filed late within two years of the filing of the bankruptcy petition.
  - (3) Taxes for which a fraudulent return was filed or there was a willful attempt to evade tax.
- c. Costs of administering the bankruptcy estate are a first priority claim. *11 U.S.C. § 507(a)(1)*. Administrative expenses include taxes, fines, penalties and reductions in credits incurred by the estate. *11 U.S.C. § 503(b)(1)(B)*.
- d. Another rule to keep in mind is that no income is realized from the discharge of indebtedness to the extent that payment of the liability would give rise to a deduction. *I.R.C. § 108(e)(2)*. Tax

attributes are not reduced to the extent of discharged interest expense or other discharged trade or business expense items. This means less reduction in the debtor's tax attributes. All operating expenses unpaid at the time of bankruptcy filing should fall into this category. Thus, depending upon timing of filing, this provision could be very significant for farmers. In general, all payments made by a debtor are deemed first applied to interest in the absence of any specification to the contrary.

- e. The bankruptcy estate receives the tax attributes of the debtor as of the beginning of the tax year in which bankruptcy is filed. *I.R.C. § 1398(g)*.
- (1) If the debtor chooses to retain a single tax year, the tax attributes held by the debtor at the beginning of that year pass to the bankrupt estate.
  - (2) In the event the bankrupt elects two short tax years, the tax attributes do not pass to the bankrupt estate until the beginning of the second short year. That means the debtor can apply the tax attributes on the debtor's income tax return for the first short tax year.
  - (3) The reduction in tax attributes is made after the determination of income tax for the taxable year of the discharge. *I.R.C. § 108(b)(4)(A)*.
  - (4) Here's the order of adjustment of tax attributes—
    - (a) Any net operating loss for the tax year in which indebtedness is cancelled must first be reduced. The same applies to any net operating loss carryover to that year. *I.R.C. § 108(b)(2)(A)*.
      - [1] The current year's net operating loss is applied first. *I.R.C. § 108(b)(4)(B)*.
      - [2] A debtor may be indirectly affected by the discharge of indebtedness in bankruptcy inasmuch as a reduction in the net operating loss from discharge of indebtedness reduces the estate's net operating loss carryback to the debtor's taxable years ending before commencement of the case. This would increase the amount of the debtor's nondischargeable tax liabilities that could be satisfied out of assets acquired by the debtor after bankruptcy filing.
    - (b) Any carryovers to or from the taxable year of discharge of—
      - [1] The credit for increasing research activities. *I.R.C. § 30*.
      - [2] General business credit (investment tax credit, targeted jobs credit and alcohol fuels credit). *I.R.C. § 108(b)(2)(B)*.
    - (c) After 1993, minimum tax credits as of the beginning of the taxable year immediately after the taxable year of discharge. *I.R.C. § 108(b)(2)(C)*.
    - (d) Net capital losses for the year of debt cancellation (and any capital loss carryover to that year) are then reduced. *I.R.C. § 108(b)(2)(D)*. The current year's net capital loss is applied first. *I.R.C. § 108(b)(4)(B)*.
    - (e) The income tax basis of the debtor's property is reduced next. *I.R.C. §§ 108(b)(2)(E), 1017*.
      - [1] There is no reduction in the income tax basis of property treated by the debtor as exempt property. *I.R.C. § 1017(c)(1)*. Keep in mind that this provision only applies to discharge of indebtedness occurring in bankruptcy.

- [2] The reduction of basis under I.R.C. § 108(b)(2)(D) applies to any property of the taxpayer (other than exempt property) whether depreciable or not, held at the beginning of the taxable year following the taxable year in which the discharge of indebtedness occurs. *I.R.C. § 1017(a)*.
- [3] The amount of basis reduction is equal to the adjusted basis of assets in the aggregate minus liabilities in the aggregate.
- [4] The reduction in basis is not treated as a disposition for purposes of recapture of investment tax credit. *I.R.C. § 1017(c)(2)*. See *Rev. Rul. 84-134, 1984-2 C.B. 6*.
- [5] Any reduction in basis is treated as a deduction allowed for depreciation. *I.R.C. § 1017(d)(1)(B)*.
  - [a] All property that is not I.R.C. §§ 1245 or 1250 property is considered to be 1245 property. *I.R.C. § 1017(d)(1)(A)*. Thus, if property (for which basis has been reduced) is later sold at a gain, the part of the gain attributable to basis reduction is taxed as ordinary income. The recapture is handled in much the same manner as recapture of depreciation on machinery.
  - [b] In calculating what would have been straight line depreciation for purposes of I.R.C. § 1250, the determination is made as if there had been no reduction in basis from discharge of indebtedness. *I.R.C. § 1017(d)(2)*.
- [6] As a general rule, the reduction in basis cannot exceed the excess of the aggregate of the basis of the property held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge. *I.R.C. § 1017(b)(2)*. Thus, basis is reduced down to the indebtedness.
- [7] The sequence of basis reduction is prescribed by *Treas. Reg. § 1.1017-1* with adjustment for each category on a prorata basis. The sequence of basis reduction is outlined below under the discussion for solvent debtors.
  - (f) Any passive activity loss or credit carryover under I.R.C. § 469(b) from the taxable year of the discharge. *I.R.C. § 108(b)(2)(F)*.
  - (g) The last reduction is for carryovers of the foreign tax credit to or for the taxable year of discharge. *I.R.C. § 108(b)(2)(G)*.
- f. For the tax attributes other than credits, the reduction is one dollar for each dollar of indebtedness cancelled. *I.R.C. § 108(b)(3)(A)*. Credits are reduced at the rate of 50 cents for each dollar of cancelled debt through 1986. *I.R.C. § 108(b)(3)(B)*. After 1986, credits are reduced 33<sup>1</sup>/<sub>3</sub> cents for each dollar of discharge of indebtedness. *Tax Reform Act of 1986, Sec. 104(b)(2)*.
- g. An election may be made to first reduce the basis of part or all of the depreciable property. *I.R.C. § 108(b)(5)*. See *Temp. Treas. Reg. § 7a.1(c)*. If the election is filed, the basis is reduced to zero. See *I.R.C. § 1017(b)(2)*. This enables the taxpayer to preserve net operating loss, capital loss and tax credit carryovers.
  - (1) The election on reducing basis of depreciable property before reducing other tax attributes is to be made on the income tax return for the tax year of debt cancellation or discharge but note that the basis is reduced on the first day of the following tax year. Form 982 is used, "Adjustment of Basis of Property Under Sections 1017 or 1081(a)(2) of the Internal Revenue Code". Once made, the election is revocable only with IRS consent.

- (2) If reasonable cause is shown, the choice may be made on an amended return or claim for refund. *Treas. Reg. § 1.108(a)(2)*. See *Jenniges v. United States*, 90-1 U.S.T.C. ¶ 50,090 (D. Minn. 1990) (no abuse of discretion in refusing late-filed election). Extensions of time for filing may be granted for good cause. *Ltr. Rul. 9150033, September 13, 1991*.
- (3) The reduction in basis is to depreciable property. *I.R.C. § 1017(b)(3)(A)*. Any real estate held for investment purposes can be treated as depreciable property if desired by the taxpayer. *I.R.C. §§ 1017(b)(3)(E)(i), 1221(1)*. The income tax basis of nondepreciable property, such as a residence or farmland, is not reduced. *I.R.C. § 108(b)(5)(C)*.
- h. The reduction in income tax basis is made at the beginning of the tax year following the tax year of debt cancellation and applies to property held at that time. *I.R.C. § 108(b)(5)(B)*. The aggregate liabilities of the taxpayer immediately after the discharge are not taken into consideration. Thus, basis could be reduced to zero despite existing indebtedness against the property. Note that if the election to reduce basis first is not made, basis can be reduced to the level of indebtedness only. This limitation on reduction of basis may be quite significant as to depreciable property.
- i. It is not clear who makes the election to reduce basis or reduce tax attributes although it would appear, as a practical matter, that the debtor should be involved in making the election. However, one commentator believes that the trustee in bankruptcy makes the election except, possibly, for property passed back to the debtor. *W. Tatlock, "Bankruptcy and Insolvency: Tax Aspects and Procedure," TM-540, 1995, p. A-25*.
- j. The rest of the amount of indebtedness discharged is not included in the taxpayer's income.
- k. For a more detailed discussion of reduction of basis by discharge of indebtedness income, see paragraph 3 below.
- l. Planning is important in handling discharge of indebtedness income.

### Example

A farm taxpayer in late 1984 turned over 320 acres of land to creditors and triggered \$100,000 of discharge of indebtedness which was used to reduce a net operating loss carryforward and investment tax credit carryforward and to reduce the income tax basis on machinery to zero. In late 1985, with the taxpayer under continuing pressure from lenders, the machinery was sold which produced ordinary income. In early 1986, the taxpayer filed for Chapter 7 bankruptcy. Had all assets been disposed of in bankruptcy, the discharge of indebtedness amount remaining after reducing the tax attributes would have been eliminated.

- m. The reduction in tax attributes and basis of property are made after the determination of income tax for the taxable year of discharge. *I.R.C. § 108(b)(4)(A)*. For Chapter 11 bankruptcy, the adjustments are made after confirmation of the plan but before termination. Any amounts excluded from gross income under *I.R.C. § 108* are applied to reduce the basis of property held at the beginning of the taxable year following the taxable year in which the discharge occurs. *I.R.C. § 1017(a)*.
- n. Discharge of indebtedness for state and local tax purposes —
  - (1) In general, income is not realized by the estate, the debtor or a successor to the debtor for state and local tax purposes because of discharge of indebtedness in a bankruptcy case. *11 U.S.C. § 346(j)(1)*. The Bankruptcy Code provisions are made "subject to the Internal Revenue Code." *11 U.S.C. § 346(a)*.
    - (a) Any net operating loss of a debtor, including a net operating loss carryover, is reduced by the amount of indebtedness forgiven or discharged in bankruptcy. *11 U.S.C. § 346(j)(3)*.

- (b) Basis is not required to be reduced below the debtor's nondischarged liabilities. *11 U.S.C. § 346(j)(5)*.
  - (c) There is no election to reduce the basis of property before reducing net operating losses and net operating loss carryovers.
  - (d) The basis of exempt property is not to be reduced in bankruptcy.
- (2) The provisions for state and local taxes do not specify that the reduction in tax attributes is to be made after the determination of tax for the taxable year of discharge.
2. Discharge of indebtedness for an insolvent debtor outside bankruptcy
- a. As a general rule, the cancellation of indebtedness for taxpayers not in bankruptcy produces income.
    - (1) However, income from the discharge of indebtedness for an insolvent taxpayer is excluded from income. *I.R.C. § 108(a)(1)(B)*. *Richard D. Frazier, 111 T.C. 243 (1998)* (insolvency exceeded amount of discharge of indebtedness so excludible). A spouse filing a joint return with an insolvent debtor does not realize discharge of indebtedness income from the debtor's discharge of indebtedness. *Deanna M. Traci, T.C. Memo. 1992-708* (facts sufficient to show that debtor's liabilities exceeded assets although debtor's net worth not clear).
    - (2) The determination of insolvency is made at the partner level where a partnership receives discharge of indebtedness income. Compare *Estate of Newman, T.C. Memo. 1990-230, rev'd, 91-1 U.S.T.C. ¶ 50,281 (2d Cir. 1991)* (insolvency exception applied at partnership level; pre-1980 law). But see *Herbert Gershkowitz, 88 T.C. 984 (1987)*. See also *James J. Jasienski, T.C. Memo. 1992-674* (no income to general partner in limited partnership on partial discharge of mortgage owed by limited partnership where partner insolvent before and after discharge).
  - b. The amount of income from the discharge of indebtedness that can be excluded from income is limited to the extent of the debtor's insolvency. *I.R.C. § 108(a)(3)*. See *Leslie M. Caton, T.C. Memo. 1995-80* (discharge of debt not excludible because taxpayer not insolvent).
    - (1) If the debt discharged would have produced an income tax deduction, the taxpayer does not have income from discharge of the indebtedness. *I.R.C. § 108(e)(2)*. See *Ltr. Rul. 8808063, December 2, 1987* (amount of income from discharge of indebtedness does not include interest expense accrued but not paid in year of discharge of accrual basis taxpayer).
    - (2) Otherwise, if the amount of the debt discharged exceeds the amount of insolvency, income is triggered as to the excess.

### Example

Alice Blackburn, with \$800,000 of debts and \$500,000 of assets, is insolvent and files bankruptcy. If \$400,000 of debts are discharged in bankruptcy, no income results from the discharge. If \$400,000 of debts are forgiven without a bankruptcy filing, only \$300,000 would be treated the same way as debt is discharged in bankruptcy. The other \$100,000 of debt would be subject to the rules for a solvent farm debtor discussed in paragraph 4 below or would be income.

- (3) In discharging indebtedness, the taxpayer's net worth may rise by more than the amount of discharge of indebtedness for income tax reporting purposes. A write-off of accrued but unpaid interest for a cash basis taxpayer and a write-off of property taxes and other obligations which are not part of discharge of indebtedness calculations may affect solvency of the taxpayer.

c. The determination of insolvency is made immediately before the discharge of indebtedness. *I.R.C. § 108(d)(3)*.

(1) Insolvency is defined as an “excess of liabilities over the fair market value of assets”. *I.R.C. § 108(d)(3)*.

(a) It appears that both tangible and intangible assets are included in the calculations.

(b) Both recourse and non-recourse liabilities are included in the insolvency computation. Apparently, contingent liabilities are not included. *Dudley B. Merkel, 109 T.C. 463 (1997), aff’d, 192 F.3d 844 (9<sup>th</sup> Cir. 1999)* (guarantee of partnership debt treated as contingent debt and not included in debts for purposes of insolvency determination).

(c) Exempt property was not included in the insolvency calculations until 1999. *Ltr. Rul. 9125010, March 19, 1991; Ltr. Rul. 9130005, March 29, 1991*. See *Rufus Cole, 42 B.T.A. 1110 (1940), nonacq, 1941-1 C.B. 13; Marcus Estate, T.C. Memo. 1975-9; Edward Davis, 69 T.C. 814 (1978); Hunt v. Commissioner, T.C. Memo. 1989-335*.

[1] However, IRS in 1999 issued a private letter ruling changing its position (and revoking *Ltr. Rul. 9125010, March 19, 1991*) and a Field Service Advice confirming the move. *Ltr. Rul. 9932013, May 4, 1999; FSA Ltr. Rul. 9932019, May 10, 1999*. See *Ltr. Rul. 9935002, May 3, 1999* (same).

[2] In 2001, the Tax Court agreed that the term “assets” includes exempt assets. *Roderick E. Carlson, 116 T.C. 87 (2001)* (value of fishing permit, exempt under state law to commercial fishermen, not excluded from assets in determining solvency); *Edward D. Johns, T.C. Summary Opinion 2001-67* (exempt property not included in determining solvency). See *Gitlitz v. Commissioner, 121 S. Ct. 701 (2001)* (judicially developed insolvency exceptions not codified in *I.R.C. § 108* are not applicable; *Merkel v. Commissioner, 192 F.3d 844 (9<sup>th</sup> Cir. 1999), aff’g, 109 T.C. 463 (1997)*).

(d) The separate assets of a debtor’s spouse are not included in determining the extent of insolvency. *Ltr. Rul. 8920019, February 14, 1989*.

(2) To determine the fact and extent of insolvency, an appraisal of assets may be necessary. See *Schrott v. Commissioner, T.C. Memo. 1989-346* (debtors not allowed insolvency exception where debtors failed to prove they were insolvent prior to discharge of indebtedness). The valuation should be as accurate and precise as possible to avoid unexpected income. To the extent that assets are revalued upward on audit, income may be triggered to the taxpayer.

### Example

Returning to the above example involving Alice Blackburn, if the assets are revalued upward to \$600,000, Ms. Blackburn would have potential income of \$200,000 rather than \$100,000 when \$400,000 of indebtedness is forgiven out of bankruptcy.

(3) Apparently, accrued but unpaid interest, income taxes that have become an obligation of the debtor, and other fixed and certain claims are allowable deductions in calculating the extent of solvency or insolvency of the debtor.

d. The tax attributes of an insolvent debtor are reduced by the amount of income that is excluded from the taxpayer’s gross income because it is from discharge of indebtedness. *I.R.C. § 108(b)(1)*.

(1) The order of reduction in tax attributes—and the extent to which the tax attributes are reduced—are the same as in bankruptcy. *I.R.C. § 108(b)(2)*. The reductions in tax attributes

are made after the determination of income tax for the year of the discharge. *I.R.C. § 108(b)(4)(A)*.

- (2) An insolvent debtor has the same option as bankrupts to reduce the income tax basis of depreciable assets first. *I.R.C. § 108(b)(5)*.
  - (a) This election is likely to be more useful than in Chapter 7 bankruptcy because the debtor is more likely to be continuing the business operation.
  - (b) The rule specifying that the basis of exempt property is not to be reduced only applies to discharge of indebtedness occurring in bankruptcy, however.
  - (c) When the election is made, use Form 982.
- (3) The reduction in basis is done at the beginning of the tax year following the cancellation of the debt.

### 3. Discharge of indebtedness for a solvent debtor (repealed effective in 1987)

- a. For a solvent non-farm debtor, there was only one possibility for avoiding income on the discharge of indebtedness through 1986. That possibility involved an election as to qualified business indebtedness. *I.R.C. § 108(a)(1)(C)*. That is indebtedness incurred or assumed by an individual in connection with property used in the individual's trade or business. The rule for solvent non-farm taxpayers was repealed in 1986 effective in 1987.
- b. The election for qualified business indebtedness required that the income tax basis of eligible assets be reduced as the price for avoiding income tax liability on discharge of indebtedness. The rules differed, however, from the provisions applicable in bankruptcy.

### 4. Discharge of real property business debt

- a. For discharges of indebtedness occurring after 1992, in tax year ending after that date, taxpayers other than C corporations may elect to exclude from gross income amounts realized from the discharge of "qualified real property business indebtedness." *I.R.C. § 108(c)*.
  - (1) The exclusion results in a reduction of the basis of depreciable real property and may not exceed the basis of depreciable real property. *I.R.C. § 108(c)(1)(A), (2)*.
  - (2) "Qualified real property business indebtedness refers to indebtedness" incurred or assumed in connection with real property used in a trade or business and secured by that real property. *I.R.C. § 108(c)(3)*.
    - (a) The term does not include qualified farm indebtedness. *I.R.C. § 108(c)(3)*.
    - (b) The term does not apply to indebtedness assumed or incurred on or after January 1, 1993, unless the indebtedness constitutes qualified acquisition indebtedness or unless it is used to refinance qualified real property business debt incurred or assumed before that date. *I.R.C. § 108(c)(3)(B)*.
- b. The amount excluded may not exceed the excess of (1) the outstanding principal amount of such debt over (2) the fair market value of the business real property that is security for the debt. *I.R.C. § 108(c)(2)(A)*. The exclusion amount also may not exceed the aggregate adjusted bases of depreciable real property held by the taxpayer immediately before the discharge. *I.R.C. § 108(c)(2)(B)*.

- c. An extension is allowed to file an election to reduce basis under the real property business debt provision. *Ltr. Rul. 9950028, September 14, 1999.*
5. Discharge of indebtedness for a solvent farm debtor
- a. Effective for discharge of indebtedness occurring after April 9, 1986, discharge of indebtedness arising from an agreement between a person engaged in the trade or business of farming and a qualified person to discharge “qualified farm indebtedness” is treated for federal income tax purposes under a special provision if specified conditions are met. *I.R.C. § 108(g)*. The insolvency rules take priority over the qualified farm indebtedness rule.
  - b. A “qualified person” is defined as someone including state and federal agencies who is “actively and regularly engaged in the business of lending money” and who is not—
    - (1) Related to the taxpayer,
    - (2) A person from whom the taxpayer acquired the property (or a related person),
    - (3) A person who receives a fee with respect to the taxpayer’s investment in the property (or a related person). *I.R.C. §§ 108(g)(3), 49(a)(1)(D)(iv)*.
  - c. The definition of “related person” is to be determined as of the close of the taxable year, *I.R.C. § 46(c)(8)(D)(v)*, and includes—
    - (1) Brothers and sisters, spouse, ancestors and lineal descendants. *I.R.C. §§ 465(b)(3)(C)(i), 267(b)(1), 267(c)(4)*.
    - (2) An individual and a corporation more than 10 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the individual and various combinations of controlled or related entities. *I.R.C. §§ 465(b)(3)(C)(i), 267(b)(2) through (12)*.
    - (3) A partnership and a person owning, directly or indirectly, more than 10 percent of the capital or profits interest in the partnership or two partnerships in which the same persons own, directly or indirectly, more than 10 percent of the capital or profits interest. *I.R.C. §§ 465(b)(3)(C)(i), 707(b)(1)*.
    - (4) Persons who are engaged in trades or businesses under common control. *I.R.C. §§ 465(b)(3)(C)(i), 52(a), (b)*.
  - d. To be eligible to be treated as “qualified farm indebtedness,” the indebtedness must be incurred directly in connection with the operation by the taxpayer of the trade or business of farming and 50 percent or more of the average annual gross receipts of the taxpayer for the three preceding taxable years must be attributable to the trade or business of farming. *I.R.C. § 108(g)(2)*. See *Joseph B. Campbell, T.C. Memo. 2001-51* (discharge of indebtedness could not be excluded under solvent farm debtor rule; failed to prove “50 percent” test was met); *FSA 9999-9999-86* (debt not qualified farm indebtedness; some members of group operated poultry farms, others were processors; test applied at separate entity level).
    - (1) The gross receipts test is applied on an aggregate basis over the three year period.
    - (2) Cash rents are not considered to be “gross receipts.” *Margaret A. Lawinger, 103 T.C. 428 (1994)* (sales of farm machinery were gross receipts but Farmland Preservation Act credits under state law were not gross receipts; receipts from farming less than 50 percent of gross receipts).
  - e. Ordering rule for handling the reduction of indebtedness income—

## (1) Tax attributes

- (a) Net operating loss for the taxable year and any carryover of losses to that year. *I.R.C. § 108(b)(2)(A)*.
- (b) General business credits, including investment tax credit for the taxable year and any carryover of credits to that year. *I.R.C. § 108(b)(2)(B)*.
- (c) The amount of the minimum tax credit under I.R.C. § 53(b) as of the beginning of the taxable year immediately following the taxable year of discharge. *I.R.C. § 108(b)(2)(C)*.
- (d) Capital losses for the taxable year and any carryover of capital losses to that year. *I.R.C. § 108(b)(2)(D)*.
- (e) Passive activity loss and credit carryovers under I.R.C. § 469(b) from the taxable year of the discharge. *I.R.C. § 108(b)(2)(F)*.
- (f) Foreign tax credits for or to the taxable year. *I.R.C. § 108(b)(2)(G)*.

(2) Basis reduction. *I.R.C. § 1017(b)(4)*.

- (a) For purposes of reduction of basis, property is limited to that used in a trade or business or for the production of income.
  - (b) The order of basis reduction is specified—
    - [1] Depreciable property.
    - [2] Land used or held for use in the trade or business of farming.
    - [3] Other qualified property. Although the statute is not clear on that point, the apparent intent is to include inventory property.
  - (c) The basis reduction rule limiting basis reduction to the debt on the property applies only to instances where the debtor is insolvent or in bankruptcy. *I.R.C. § 1017(b)(2)*. Therefore, it appears that basis is reduced to zero in instances involving a solvent farm debtor under I.R.C. § 108(g).
- f. An election can be made to reduce the basis of depreciable property first. *I.R.C. § 108(b)(1), 108(b)(5)*.
- g. The amount of the exclusion may not exceed the aggregate amount of the attributes and basis reduction described above and income must be recognized to the extent the amount of discharged indebtedness exceeds the available tax attributes and basis.

## 6. Purchase price adjustment

- a. A fifth limited exception to the general rule that discharged indebtedness constitutes income is applicable to instances where the reduction of a purchase money debt constitutes a purchase price adjustment. *I.R.C. § 108(e)(5)*.
  - (1) In the event that the debt of an original purchaser of property is reduced by the original seller of the property, the adjustment is treated as a purchase price adjustment and not as discharge of indebtedness under the regular rules if the debtor is solvent. *I.R.C. § 108(e)(5)*.

- (a) The reduction has been approved following a tax-free exchange under I.R.C. § 351. *Ltr. Rul. 9037033, June 18, 1990* (reduction of accrued unpaid interest (with application of tax benefit rule) followed by reduction of principal).
  - (b) A debt reduction involving a third party lender may be treated as a purchase price reduction only to the extent that the reduction relates back to the original sale. *Rev. Rul. 92-99, 1992-2 C.B. 35* (under secured seller of property).
  - (c) A purchase price reduction has been approved after a merger of the buyer. *Ltr. Rul. 9338029, June 25, 1993*. See *Ltr. Rul. 9338049, June 15, 1993*.
  - (d) Settlement with a lender's successor (FDIC) rather than with the seller of property may preclude application of the purchase price adjustment exception. *Preslar v. Commissioner, 167 F.3d 1323 (10<sup>th</sup> Cir. 1999)*.
- (2) The purchase price adjustment rule does not apply if the debtor is insolvent or in bankruptcy. *I.R.C. § 108(e)(5)(B)*. However, IRS will not challenge a partnership's treatment of a reduction of an indebtedness owed by the partnership as a purchase price adjustment if the transaction would qualify as a purchase price adjustment otherwise and no partner adopts an inconsistent reporting position. *Rev. Proc. 92-92, 1992-2 C.B. 505*.
- (3) The reduction must be based solely on direct, arm's length negotiations between the original buyer and the original seller.
- b. The reduction in basis for the property is not elective. See *I.R.C. § 108(e)(5)*.
- c. Reduction of basis under the purchase price adjustment rule is governed by rules different from reduction of basis under other provisions—
- (1) Investment tax credit recapture occurs to the extent of the reduction in basis inasmuch as *I.R.C. § 1017(c)(2)* which protects against investment tax credit recapture does not apply. The holding period apparently is deemed to be "less than 3 years" so the investment tax credit is fully recaptured to the extent of the reduction in basis even though the time for recapture otherwise has passed. See *Treas. Reg. § 1.47-2(c)(1)*.
  - (2) Debt reduction as a purchase price adjustment is not debt discharge income so the reduction is not subject to later recapture under *I.R.C. §§ 1245, 1250*.
  - (3) With the reduction in basis, an adjustment is made in depreciation claimed. Basis is also modified for purposes of figuring gain or loss on later sale.
  - (4) What if some assets (buildings, fences, tile lines, for example) have been depreciated out or at least depreciated to a level not permitting a proportionate reduction in basis? Neither the regulations nor the statute provide a direct answer to the question. *I.R.C. §§ 168, 1011, 1016, 1017. Prop. Treas. Reg. § 1.168-2(d)(3); Treas. Reg. § 1.1017-1*.
    - (a) One argument is that the taxpayer has income to the extent the basis reduction allocable to a depreciable item exceeds the basis in the item at the time of basis reduction. *Cf. Estate of Delman, 73 T.C. 15 (1979)*.
    - (b) The other argument, under the assumption that relief provisions should be construed reasonably to achieve the relief objectives, is that the basis would be reduced using the relative adjusted basis figures at the time of basis reduction with relatively greater basis reduction for the land and other nondepreciable assets. *Treas. Reg. § 1.1017-1(a)(3)*.

- d. IRS has approved a reduction of tax attributes under the insolvent debtor rule followed by a purchase price reduction under I.R.C. § 108(e)(5). *Ltr. Rul. 9037033, June 18, 1990.*
  - e. The seller who agrees to a purchase price adjustment may have income from cancellation of the obligation. *I.R.C. § 453B(f)*. But see *Ltr. Rul. 8739045, June 30, 1987* (no income to seller in canceling indebtedness as part of restructuring of installment contract; no recognition of 1980 enactment of I.R.C. § 453B(f)).
    - (1) If the parties are not related within the meaning of the I.R.C. § 453B(f)(1), the gain is determined by the fair market value of the obligation. *I.R.C. §§ 453B(f)(1), 453B(a)(2)*.
    - (2) In the event the parties are related, the fair market value of the obligation is treated as not less than its face amount. *I.R.C. § 453B(f)(2)*.
7. Discharge of indebtedness for purposes of state and local taxes.
- a. The Bankruptcy Code contains provisions applicable to state and local taxes relative to discharge of indebtedness comparable to I.R.C. § 108. See *11 U.S.C. § 346(j)*.
  - b. In general, income is not realized by the estate, the debtor or a successor to the debtor for state and local tax purposes because of discharge of indebtedness in a bankruptcy case. *11 U.S.C. § 346(j)(1)*.
  - c. Any net operating loss of a debtor, including a net operating loss carryover, is reduced by the amount of indebtedness forgiven or discharged in bankruptcy. *11 U.S.C. § 346(j)(3)*. The net operating loss must be reduced before basis is reduced.
  - d. Basis is not required to be reduced below the debtor's nondischarged liabilities. *11 U.S.C. § 346(j)(5)*.
  - e. There is no election to reduce the basis of property before reducing net operating losses and net operating loss carryovers.
  - f. The rules governing state and local taxes do not provide that the basis of exempt property is not to be reduced in bankruptcy.
  - g. The provisions for state and local taxes do not specify that the reduction in tax attributes is to be made after the determination of tax for the taxable year of discharge.
  - h. The Bankruptcy Code provisions are made "subject to the Internal Revenue Code..." *11 U.S.C. § 346(a)*.
8. Reduction of income tax basis
- a. If a taxpayer has more than one item of depreciable property, the question arises as to how basis reduction is to be allocated among the items of property.
    - (1) I.R.C. § 1017(b)(1) specifies that the allocation is to be determined by regulation.
    - (2) The legislative history of the Bankruptcy Tax Act of 1980 indicates that the order of basis reduction among depreciable property items is to be in accord with the existing regulations in *Treas. Reg. §§ 1.1017-1 and 1.1017-2*. See *S. Rep. No. 96-1035, 96<sup>th</sup> Cong., 2d Sess. 15 (1980)*.
    - (3) Under the existing regulations, money is excluded from basis reduction and any reduction is prohibited that would result in a negative basis. *Treas. Reg. § 1.1017-1*.

- (a) The ordering rules establish four categories of property for corporate debtors—
- [1] Non-inventory property acquired through incurrence of the cancelled debt;
  - [2] Non-inventory property which secures the cancelled debt;
  - [3] Other non-inventory property; and
  - [4] Inventory and receivables.
- (b) For individual debtors, there are six categories of property—
- [1] Non-inventory property used in the trade or business acquired through incurrence of the cancelled debt;
  - [2] Non-inventory property used in the trade or business which secures the cancelled debt;
  - [3] Other non-inventory property used in the trade or business;
  - [4] Inventory and receivables used in the trade or business;
  - [5] Property held for the production of income; and
  - [6] Other property. *Treas. Reg. § 1.1017-1(a)*.
- (c) In general, the regulations require the basis reduction to be allocated to property within each category eliminating any remaining basis in property in that category before property in the next category is subjected to basis adjustment. *Treas. Reg. § 1.1017-1(a)*.
- [1] As an exception to the general rule, depreciable, amortizable or depletable property in category [3] for corporate and non-corporate taxpayers is subjected to the basis adjustment before property in category [2] which is not depreciable, amortizable or depletable. *Treas. Reg. § 1.1017-1(b)(7)*.
  - [2] Within any particular category after category [2], if there are multiple assets, the basis reduction is to be allocated among such assets in proportion to relative adjusted bases.
  - [3] A taxpayer may have the basis of the property adjusted in a different manner upon approval of the Commissioner on a request filed with the return for the taxable year of the discharge of indebtedness. *Treas. Reg. § 1.1017-2(a)*. The requested variation in adjustment method must be consistent with the general principles of the regular method of adjustment. *Treas. Reg. § 1.1017-2*. See *Rev. Proc. 85-44, 1985-2 C.B. 504* (conditions under which IRS will issue advance rulings and closing letters permitting a variation from the general rule). Under *Rev. Proc. 85-44*, IRS will not issue an advance ruling or enter into a closing agreement if it appears the taxpayer will gain a significant tax advantage by adjusting the basis of only selected assets. An advance ruling or closing agreement may be obtained if the taxpayer is not insolvent or bankrupt, the discharged indebtedness is not treated as a price reduction, the taxpayer has no preconceived plan or intention to dispose of the assets, the selected assets are depreciable having a weighted average remaining 'useful life' no longer than the weighted average remaining 'useful life' of all the taxpayer's depreciable properties excluding fully depreciated assets, the taxpayer has sufficient bases to absorb the basis adjustment, in no instance will basis be reduced below salvage value and the assets are not depreciable under the retirement-

replacement–betterment method. In addition, the taxpayer must agree to treat basis reduction as ordinary income on later sale and to adjust depreciation subsequently claimed accordingly. See *Ltr. Rul. 8544001, July 12, 1985; Ltr. Rul. 8544005, April 23, 1985; Ltr. Rul. 8544006, April 24, 1985; Ltr. Rul. 8544007, April 24, 1985; Ltr. Rul. 8544008, April 24, 1985; Ltr. Rul. 8544019, July 29, 1985; Ltr. Rul. 8544022, April 23, 1985; Ltr. Rul. 8544052, August 6, 1985; Ltr. Rul. 8545009, April 24, 1985; Ltr. Rul. 8552013, August 8, 1985; Ltr. Rul. 8552014, August 8, 1985; Ltr. Rul. 8552020, August 8, 1985; Ltr. Rul. 8624098, February 10, 1986; Ltr. Rul. 8709008, October 24, 1986; Ltr. Rul. 8746005, June 26, 1987; Ltr. Rul. 8748005, June 26, 1987; Ltr. Rul. 8824005, January 29, 1988; Ltr. Rul. 8840021, June 3, 1988; Ltr. Rul. 8926003, January 30, 1989.*

- (d) Some have argued in favor of a simpler three tier classification rather than the above—
  - [1] Depreciable property acquired through incurrence of the cancelled debt;
  - [2] Depreciable property which specifically secures the cancelled debt;
  - [3] Other depreciable property. See *Pollack, “How Section 108 Election Permits Debt Cancellation Income To Be Minimized,” 62 J. Tax. 276 (1985)*. With this approach, basis adjustment would be allocated first to property in category [1] with any excess allocated to properties in category [2] and with any further excess allocated to properties in category [3].
- (4) Regulations have been adopted that simplify the basis reduction process with basis reduction occurring in the following order—
  - (a) Real property used in a trade or business or held for investment (other than real property described in I.R.C. § 1221(1)) that secured the discharged indebtedness immediately before the discharge. *Treas. Reg. § 1.1017-1(a)(1)*.
  - (b) Personal property used in a trade or business or held for investment, other than inventory, accounts receivable and notes receivable, that secured the indebtedness immediately before the discharge. *Treas. Reg. § 1.1017-1(a)(2)*.
  - (c) Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in I.R.C. § 1221(1). *Treas. Reg. § 1.1017-1(a)(3)*.
  - (d) Inventory, accounts receivable, notes receivable and real property described in I.R.C. § 1221(1). *Treas. Reg. § 1.1017-1(a)(4)*.
  - (e) Property not used in a trade or business or held for investment. *Treas. Reg. § 1.1017-1(a)(5)*.
- (5) Taxpayers may choose whether to request that a partnership reduce the partners’ shares of depreciable basis in partnership property and thus permit the partnership interest to be treated as depreciable property or as depreciable real property. *Treas. Reg. § 1.1017-1(g)*.
- b. The depreciation deduction allowable with respect to recovery property is to be redetermined if the basis of the property is reduced under I.R.C. § 1017. See *I.R.C. § 168(d)(1)(B)(ii)*.
  - (1) The recovery allowance for the taxable year in which the unadjusted basis of recovery property is redetermined, and for subsequent taxable years, equals the amount determined by multiplying the “redetermined adjusted basis” by the “redetermined applicable percentage”. *Prop. Treas. Reg. § 1.168-2(d)(3)*.

- (a) The redetermined adjusted basis equals the unadjusted basis (in most instances, the basis for purposes of determining gain) reduced by—
  - [1] The recovery allowance previously allowed or allowable with respect to the property, and
  - [2] The amount of the basis reduction under I.R.C. § 1017.
- (b) The redetermined applicable percentage is the percentage determined by dividing—
  - [1] The applicable percentage otherwise provided for the recovery year by
  - [2] The excess of 100 over the sum of the applicable percentages for recovery years prior to the year in which the basis is redetermined.
- (2) The effect of the redetermination rule is to reduce the depreciation deduction allowed to the taxpayer over each taxable year after the election in proportion to the depreciation otherwise allowable. Thus, it is to the taxpayer's advantage to allocate the reduction in basis to property with a longer depreciable life.
- c. The income tax basis reduction resulting from the basis reduction election is treated as a deduction allowed for depreciation for purposes of I.R.C. §§ 1245 and 1250.
  - (1) If the reduced basis property is Section 1245 property or Section 1245 recovery property, the income tax basis reduction is recaptured as ordinary income on the sale of the property to the extent of any gain realized. *I.R.C. § 1017(d)(1)(A)*. If the property is neither Section 1245 property nor Section 1250 property, the property must be treated as Section 1245 property for this purpose. *Id.*
  - (2) If the reduced basis property is Section 1250 property, the determination of what would have been the depreciation adjustments under the straight line method for purposes of Section 1250 is to be made as if there had been no basis reduction. *I.R.C. § 1017(d)(2)*.
    - (a) An individual debtor may thus convert the recapture of the basis reduction from ordinary income to capital gain.

**Example**

An individual taxpayer on a calendar year basis of reporting acquired a pole barn for \$15,000 on January 1, 1983. The taxpayer elected straight line cost recovery over 18 years so the barn remained subject to Section 1250 recapture. By the end of 1985, the adjusted income tax basis in the barn was \$11,850. On May 1, 1985, the taxpayer realized cancellation of indebtedness income and elected to exclude the amount from gross income by reducing the basis in depreciable property. Of the total basis reduction amount, \$3,000 is allocable to the barn. With the basis adjustment taking place at the beginning of the taxable year following the discharge of indebtedness, the taxpayer's adjusted income tax basis in the barn as of January 1, 1986 would be \$8,850 (\$11,850 less \$3,000). The maximum portion of the gain attributable to the income tax basis adjustment that is subject to recapture would be —

<i>Beginning of year in which disposition occurs</i>	<i>Accumulated depreciation and basis adjustment</i>	<i>Accumulated depreciation with no basis adjustment</i>	<i>Potential ordinary income recapture</i>
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1-1-85	6,934.20	4,200.00	2,734.20
1-1-86	7,718.40	5,250.00	2,468.40
1-1-87	8,502.60	6,300.00	2,202.60
1-1-88	9,286.80	7,350.00	1,936.80
1-1-89	10,071.00	8,400.00	1,671.00
1-1-90	10,855.20	9,450.00	1,405.20
1-1-91	11,639.40	10,500.00	1,139.40
1-1-92	12,311.55	11,400.00	911.55
1-1-93	12,983.70	12,300.00	683.70
1-1-94	13,655.85	13,200.00	455.85
1-1-95	14,328.00	14,100.00	228.00
1-1-96	15,000.00	15,000.00	0

- (b) Corporate debtors are required to recapture as ordinary income up to 20 percent of the basis reduction. *I.R.C. §§ 291(a), 291(e)(2)*. This is in addition to recapture as ordinary income of up to 20 percent of the actual depreciation claimed. *Id.*
- (c) If Section 1250 property is owned by a partnership and the partnership disposes of the property at a gain after the property is depreciated out, a partner should have no ordinary income recapture. The same result should obtain if the partner sold the partnership interest at a gain after the property is depreciated out although it could be argued that the partnership interest is neither Section 1245 property nor Section 1250 property and, therefore, would be treated as Section 1245 property for purposes of recapture.
- d. For planning purposes, where possible it is generally advantageous to apply the basis reduction to Section 1250 property and to Section 1250 property with relatively long remaining depreciable lives and which are not expected to be disposed of in the foreseeable future. Keep in mind that the reduction in basis is deemed to have occurred at the beginning of the taxable year following the taxable year in which the discharge of indebtedness occurs.
- (1) This can be managed by disposing of Section 1245 property before the end of the taxable year in which indebtedness was cancelled.
  - (2) Attention should be given to acquiring additional Section 1250 property, if possible and where advantageous, before the start of the following taxable year when the basis reduction is deemed to have occurred.
  - (3) Similarly, it may be advantageous to delay acquisition of Section 1245 property until after the start of the following taxable year.
  - (4) Remember, if the indebtedness discharged was secured by a lien on property, the entire basis reduction amount (or as much of it as possible) is allocated to that property. Therefore, it may be important to dispose of that property, especially if it is Section 1245 property, before the close of the taxable year in which the discharge of indebtedness occurred.
  - (5) To avoid income from discharge of indebtedness, attention should be given to acquiring sufficient property to absorb basis reduction before the end of the taxable year in which the discharge of indebtedness occurs.
- C. If a taxpayer's debt is paid by a related party assuming the liability, the amount becomes subject to the rules governing discharge of indebtedness. See *Rev. Proc. 2000-33, I.R.B. 2000-36* (guidance provided on whether acquisition of corporate debt by beneficiary of decedent creditor's estate or by beneficiary of revocable trust that becomes irrevocable at death is direct acquisition of debt under *Treas. Reg. § 1.108-2(b)*).
1. The term "related party" is defined in *I.R.C. § 267(b)* and *I.R.C. § 707(b)(1)*, as limited by *I.R.C. § 108(e)(4)(B)*, and includes—

- a. A spouse,
  - b. Children and grandchildren,
  - c. Parents,
  - d. Spouses of children and grandchildren,
  - e. An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by the individual,
  - f. Two corporations which are members of the same controlled group,
  - g. A grantor and a fiduciary of any trust,
  - h. A fiduciary of a trust and a fiduciary of another trust if the same person is a grantor of both trusts,
  - i. A fiduciary of a trust and a beneficiary of such trust,
  - j. A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts,
  - k. A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust,
  - l. A person and a Section 501 charitable organization which is controlled, directly or indirectly, by such person,
  - m. A corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital or profits interest in the partnership,
  - n. An S corporation and another S corporation if the persons own more than 50 percent in value of the outstanding stock of each corporation,
  - o. An S corporation and a C corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation,
  - p. A partnership and a partner owning, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership, or
  - q. Two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital or profits interest.
2. The acquisition of outstanding indebtedness by a person related to the debtor from a person who is not related to the debtor results in the debtor's realization of discharge of indebtedness income, measured by reference to the fair market value of the indebtedness on the acquisition date.
    - a. This rule also applies to transactions in which the holder of the outstanding indebtedness becomes related to the debtor if the holder is treated as having acquired the indebtedness in anticipation of becoming related to the debtor.
      - (1) Specifically, the rule applies where the creditor becomes related to the debtor, if

- (a) The creditor acquired the indebtedness less than six months before becoming related to the debtor, or
  - (2) On the day the creditor becomes related to the debtor, the indebtedness of the debtor represents more than 25 percent of the fair market value of the creditor's assets or the assets of all persons related to the debtor after the creditor becomes related to the debtor.
- (2) If the creditor becomes related to the debtor between 6 to 24 months before becoming related to the debtor, the rule applies unless the creditor can demonstrate that the indebtedness was not acquired in anticipation of the creditor becoming related to the debtor.
- (3) The rule does not apply to indebtedness
- (a) Acquired by the debtor with a maturity date within one year of the indebtedness being acquired by a related person, if the indebtedness is retired on that date, or
  - (b) Acquired by a dealer of securities in the ordinary course of business. *Prop. Treas. Reg. § 1.108-2* (applicable to transactions on or after March 21, 1991). See *Notice 91-15, 1991-1 C.B. 319* (proposed regulation applies to nonrecognition transactions on or after March 21, 1991, only if —
    - [1] Creditor or predecessor acquired indebtedness or became related to debtor in transaction prior to nonrecognition transaction and that would have been direct or indirect acquisition if prior transaction occurred on or after March 21, 1991 and
    - [2] Debtor did not report discharge of indebtedness income as result of creditor's or predecessor's acquisition of indebtedness or becoming related to debtor).
  - b. Steps taken to avoid related-party status may be disregarded if necessary to prevent taxpayer avoidance of realization of discharge of indebtedness income. *Rev. Rul. 91-47, 1991-2 C.B. 16* (third party's formation of corporation with subsequent sale of stock to debtor disregarded because no business purpose served).

D. Timing considerations for realization of income in foreclosure and forfeiture

1. In the event of foreclosure, gain or loss is not realized until expiration of the right to redeem. See *R. O'Dell & Sons, Inc. v. Commissioner, 169 F.2d 247 (3d Cir. 1948)*.
  - a. The taxpayer must report as gain (or loss) the difference between the income tax basis in the property and the amount of the foreclosure sale proceeds. *Cox v. Commissioner, 68 F.3d 128 (5<sup>th</sup> Cir. 1995)*.
  - b. Consideration should be given to filing bankruptcy before expiration of the right to redeem if significant income tax liability is involved. But that is not always successful. *Evert E. Berglund, T.C. Memo. 1995-536* (taxpayers had to recognize gain from foreclosure sale of farmland).
2. For forfeitures of installment contracts or conveyances of assets to a creditor in lieu of foreclosure, gain or loss is realized at the date of the transfer.
3. Property sold under threat of foreclosure is not eligible for involuntary conversion treatment. *Robert J. Recio, T.C. Memo. 1991-215*.

E. Duty imposed on secured lenders to report

1. A lender whose business loan is secured by property and who acquires an interest in that property in full or partial satisfaction of indebtedness (or has reason to know that the property has been

abandoned) is required to file a Form 1099-A with IRS and furnish a statement to the debtor. *I.R.C. § 6050J(a),(e)*. See *Richard W. Corduan, T.C. Summary Opinion 2001-74* (debt not discharged in year Form 1099-A received; taxpayer continued to make payments).

- a. If the borrower is personally liable for repayment of the debt, the Form 1099-A is to state the fair market value of the property at the time the interest is acquired. *Temp. Treas. Reg. § 1.6050J-1T (Q&A 26)*.
  - (1) In the absence of clear and convincing evidence to the contrary, the proceeds of sale on foreclosure, execution or other sale are considered to be the fair market value of the property. *Temp. Treas. Reg. § 1.6050J-1T (Q&A 32)*.
  - (2) However, the bid price of a creditor holding a security interest in the property is not considered the fair market value where the bid is the loan balance. See *Ltr. Rul. 8808017, November 24, 1987* (lender could not use bid price, which represented loan balance, or net proceeds, which represented bid price less costs of foreclosure and resale of property, as fair market value).
- b. The requirement does not apply to a loan secured by tangible personal property which is not held for investment and which is not used in a trade or business. *I.R.C. § 6050J(b)*.
- c. The reporting requirement applies to governmental units without regard to the trade or business requirement. *I.R.C. § 6050J(d)*.
- d. The reporting requirements apply to acquisitions of property and abandonments of property after December 31, 1984. *Tax Reform Act of 1984, Pub. L. 98-369, Sec. 148(d)*.

#### F. Reporting discharge of indebtedness

1. A financial entity which discharges \$600 or more of indebtedness is required to report the discharge to the Internal Revenue Service. *I.R.C. § 6050P*. See *Ltr. Rul. 200131027, May 9, 2001* (bank not subject to discharge of indebtedness reporting under *Treas. Reg. § 1.6050P-1(b)(2)*; neither a decision nor a policy triggered cancellation of credit card holder's obligation).
  - a. Debt is considered discharged and reporting is required only if the following events occur —
    - (1) Debt is discharged in bankruptcy.
    - (2) Debt cancellation occurs as a result of a foreclosure or similar proceeding.
    - (3) The statute of limitations has run on the claim or on commencing a deficiency judgment claim.
    - (4) Debt cancellation under a creditor's election of foreclosure remedies.
    - (5) The debt becomes unenforceable as a result of a probate or similar proceeding.
    - (6) An agreement between the financial entity and the debtor to discharge the debt is less than full consideration.
    - (7) Decision by the creditor to discontinue collection activity.
    - (8) The "non-payment testing period" has expired which is 36 months of non payment plus the months the creditor was precluded from engaging in any collection activity. *Treas. Reg. § 1.6050P-1(b)*.

- (a) There is a rebuttable presumption that the nonpayment testing period of item (8) has expired if the specified conditions are met. *Treas. Reg. § 1.6050P-1(b)(2)(iv)*.
  - (b) However, the presumption may be rebutted if the creditor or a collection agency has engaged in “significant, bona fide collection activity at any time during the 12-month period ending at the close of the calendar year.” *Id.* The term “significant, bona fide collection activity” does not include nominal actions such as automated mailings. *Id.*
  - (c) The presumption may also be rebutted if facts and circumstances existing as of January 31 of the calendar year following expiration of the 36-month period indicate that the indebtedness has not been discharged. *Id.* This can be shown through the existence of a lien or the sale or packaging for sale of the indebtedness by the creditor. *Id.*
- b. The discharged debt is reported on Form 1099-C, Cancellation of Debt.
    - (1) When IRS receives Form 1099-C for a taxpayer with joint and several liability on an indebtedness, the full amount of indebtedness is not treated as income to each separate taxpayer. *SCA 1998-039*. Guarantors and sureties are not required under *Treas. Reg. § 1.6050P-1(d)(7)* to report discharges of the guaranteed indebtedness because they are not themselves debtors. *Id.*
    - (2) The allocation of discharge of indebtedness as between married co-obligors is based on the use of the debt proceeds and claimed interest deductions. *CCA Ltr. Rul. 200023001, February 4, 1999* (separate returns filed).
  - c. A guarantor is not considered a debtor for purposes of the reporting requirements. *Treas. Reg. § 1.6050P-1(b)(7)*. That is the case whether or not there has been a default and demand for payment made on the guarantor. *Id.*
  - d. The regulations are effective for discharges of debt after December 21, 1996. *Treas. Reg. § 1.6050P-1(h)*. Until that time, Temp. *Treas. Reg. § 1.6050P-1* continues to apply. In addition, the interim relief from penalties applies. *Notice 94-73, 1994-2 C.B. 553*.
  - e. In 1999, the reporting requirement was extended to any organization “a significant trade or business of which is the lending of money.” *Pub. L. 106-170, 113 Stat. 1860, 1931 (1999)*. Penalties will not be imposed for failure to file information returns or furnish payee statements under I.R.C. § 6050P for discharges of indebtedness occurring before January 1, 2001. *Notice 2000-22, I.R.B. 2000-16* (applicable to those affected by the 1999 enactment).
- 2. A copy is required to be furnished to the debtor.
  - 3. A secured creditor satisfies the requirements for filing a Form 1099-A under I.R.C. § 6050J by filing a Form 1099-C under I.R.C. § 6050P. *Treas. Reg. § 1.6050P-1(e)(3)*.
- G. Tax consequences of acquisition of property by lenders—
- 1. Property acquired by a lender through voluntary conveyance constitutes a purchase of used property for investment tax credit purposes. See *Ltr. Rul. 8621003, February 14, 1986*. The lender’s cost for purposes of calculating investment tax credit is the fair market value of the property at the time of the transfer.
  - 2. A lender should be eligible to claim depreciation on the property (if rented out) in its trade or business of renting out foreclosed property or property acquired by voluntary conveyance.

## V. Corporations and partnerships as debtors

- A. Under Chapter 7, a corporate debtor is liquidated. In a Chapter 11 or 12 proceeding, the bankruptcy reorganization could take the form of either a recapitalization (usually a “type G”), in which event the corporate entity would be preserved, or a transfer of assets to another corporation with liquidation of the debtor corporation.
- B. Discharge of indebtedness
1. In a Chapter 7 case, a corporate debtor does not receive a discharge. *11 U.S.C. § 727(a)(1)*. Therefore, income from the discharge of indebtedness should not arise.
  2. In a Chapter 11 or 12 reorganization, a discharge is received which should give rise to discharge of indebtedness and the reduction of tax attributes. See *I.R.C. §§ 108, 1017*.
  3. For corporate transfers of stock to a creditor after July 18, 1984, and involving bankruptcy filings before January 1, 1995, in satisfaction of indebtedness, the corporation is treated as having satisfied the indebtedness for an amount of money equal to the fair market value of the stock. *I.R.C. § 108(e)(10)(A)*. Thus, debt discharge income arises equal to the extent the amount of the debt exceeds the value of the stock. *Id.*
    - a. This rule does not apply in a bankruptcy case or to the extent the debtor is insolvent. *I.R.C. § 108(e)(10)(B)*.
    - b. The stock-for-debt exception, in an exchange of preferred stock for indebtedness, applies only to the extent of the redemption price and liquidation preference of the preferred stock. *Rev. Rul. 90-87, 1990-2 C.B. 32*.
  4. Legislation enacted in 1990 —
    - a. For purposes of determining the amount of cancellation of indebtedness income on issuance of a new corporate debt instrument in satisfaction of an old debt, the debtor is treated as having satisfied the old debt with the amount of money equal to the issue price of the new debt.
    - b. The legislation also repeals the stock-for-debt exception (except in certain *de minimis* cases) for bankruptcy cases and insolvent debtors for taxpayers issuing disqualified stock in exchange for debt. Disqualified stock is any stock with a stated redemption price and that either has a fixed redemption date, is callable by the issuer or is puttable by the holder. *RRA 1990, Sec. 11325(a), amending I.R.C. § 108(e)*.
    - c. In general, the provision is effective for debt instruments issued or stock transferred after October 9, 1990, in satisfaction of debt. *RRA 1990, Sec. 11325(c)*.
  5. For those in bankruptcy or to the extent the debtor is insolvent, issuance of stock by a corporate debtor to cancel its indebtedness does not generate discharge of indebtedness income. See *I.R.C. § 108(e)(10)(B)*.
    - a. But this exception does not apply to the issuance of nominal or token shares or to transfers to an unsecured creditor in a workout where the ratio of the value of the stock received to the indebtedness cancelled or exchanged in the workout is less than 50 percent of a similar ratio calculated for all unsecured creditors participating in the workout. *I.R.C. § 108(e)(8)*.
    - b. What is nominal or token is subject to a facts and circumstances test with regulations focusing on the following factors as indicative that the stock exchanged for indebtedness would not be nominal or token —

- (1) The stock to debt ratio,
  - (2) The creditor's stock to total consideration ratio, or
  - (3) The stock to total stock ratio. *Treas. Reg. § 1.108-1(b)*.
- c. If common stock is issued for outstanding unsecured indebtedness in a bankruptcy case or insolvency workout, the issuance is not treated as nominal or token if the ratio of issued stock to total outstanding stock is 15 percent or less. *Rev. Proc. 94-26, 1994-1 C.B. 612*.
6. The Revenue Reconciliation Act of 1993 repealed the stock for debt exception (allowing insolvent debtors to issue stock in satisfaction of debt without creating cancellation of indebtedness income effective for stock transferred in satisfaction of debt after December 31, 1994. *RRA, § 13226(a), amending I.R.C. § 108(e)*).
    - a. A bankrupt or insolvent corporation may exclude from income all or a portion of cancellation of indebtedness income created by the transfer of its stock by reducing tax attributes.
    - b. The amendments do not apply to stock transfers in satisfaction of any indebtedness if the transfer is in a bankruptcy case filed on or before December 31, 1993. *RRA, § 13226(a)(3)(B)*.
  7. The rule that shareholder cancellation of a corporation's debt as a contribution to capital does not give rise to discharge of indebtedness income is limited to the extent of the shareholder's adjusted basis in the debt. *I.R.C. § 108(e)(6)*. See *Ltr. Rul. 9822005, January 16, 1998* (parent corporation's cancellation of debt evidenced by receivables did not result in cancellation of indebtedness income; issue price, adjusted basis and fair market value of receivables equal). For S corporations, a shareholder's adjusted basis in indebtedness is determined without regard to any adjustment in basis of indebtedness under *I.R.C. § 1367(b)(2)*. See *I.R.C. § 108(d)(7)(C)*.
  8. For S corporations, the exclusion from gross income under *I.R.C. § 108(a)* and the rules governing reduction of tax attributes under *I.R.C. § 108(b), (c)*, are applied at the corporate level. *I.R.C. § 108(d)(7)(A)*. See *John Franklin Foust, T.C. Memo. 1997-446* (federal disaster payments and federal crop insurance payments applied to discharge debts of S corporation; income from debt discharge flowed through to shareholders); *Gerald E. Toberman, T.C. Memo. 2000-221* (taxpayers in S corporation realized ordinary income on discharge of debt owed to corporation; failed to establish obligation was guarantee; not eligible for insolvency exception).
    - a. The U.S. Supreme Court has held that discharge of indebtedness income is a pass-through item of corporation income with attribute reduction after the basis adjustment and pass-through; the shareholder must pass through the discharged debt, increase the corporate basis and then deduct their losses, all before an attribute reduction occurs. *Gitlitz v. Commissioner, 182 F.3d 1143 (10<sup>th</sup> Cir. 1999)*, *rev'd, 2001-1 U.S.T.C. ¶ 50,147 (Sup. Ct. 2001)*, *original decision vacated by 10<sup>th</sup> Circuit Court of Appeals, 01-1 U.S.T.C. ¶ 50,319 (10<sup>th</sup> Cir. 2001)*. For prior cases see *Mel T. Nelson, 110 T.C. 114 (1998)*, *aff'd, 182 F.3d 1152 (10<sup>th</sup> Cir. 1999)*; *Friedman v. Commissioner, 00-1 U.S.T.C. ¶ 50,515 (6<sup>th</sup> Cir. 2000)*; *Eberle v. Commissioner, 01-1 U.S.T.C. ¶ 50,390 (9<sup>th</sup> Cir. 2001)*; *Robert H. Bettisworth, T.C. Memo. 2000-30* (S corporation could not increase basis in stock); *Richard D. Mullen, T.C. Memo. 2000-21* (same); *Stephen L. Goodman, T.C. Memo. 2000-23* (same); *Ltr. Rul. 9423003, February 28, 1994*; *Ltr. Rul. 9541006, July 5, 1995*. See *Ltr. Rul. 9403003, September 29, 1993* (excluded discharge of indebtedness income could not be used to increase stock basis). Compare *United States v. Farley, 202 F.3d 198 (3d Cir. 2000)* (shareholders of insolvent S corporation could increase stock basis by corporation's discharge of indebtedness income); *Pugh v. Commissioner, 213 F.3d 1324 (11<sup>th</sup> Cir. 2000)*, *rev'g, T.C. Memo. 1999-38* (shareholder could increase basis in S corporation stock by amount of discharge of indebtedness income; shareholder entitled to capital loss deduction); *Gaudiano v. Commissioner, 216 F.3d 524 (6<sup>th</sup> Cir. 2000)*, *remanded to Tax Court, 01-1 U.S.T.C. ¶ 50,278 (6<sup>th</sup> Cir. 2001)* (discharge of indebtedness offset losses at S corporation level; rest passed through to increase basis of shares); *Hogue v. United States, 00-1 U.S.T.C. ¶ 50,149 D. Or. 2000* (shareholders of bankrupt S

corporation could increase basis by their share of discharge of indebtedness income).

- (1) The Seventh Circuit Court of Appeals had held that discharge of indebtedness income of an S corporation can offset existing suspended losses arising from corporate operations. *Witzel v. Commissioner*, 200 F.3d 496 (7<sup>th</sup> Cir. 2000) (belief that basis should be increased). The case has been reversed and remanded in accord with *Gilitz v. Commissioner*, 200 F.3d 496 (7<sup>th</sup> Cir 2001).
  - (2) Instead, the corporation reduces its tax attributes by the amount of discharge of indebtedness income after effecting any pass through of corporation income, loss or deduction to the shareholders. *Ltr. Rul. 9541001*, November 30, 1994.
- b. An S corporation, in applying *I.R.C. § 108(b)(2)*, does not reduce net operating losses carried forward from a period when it was a C corporation. *Id.*
  - c. Extensions of time can be granted to make an election to exclude income from discharge of indebtedness from gross income. *Ltr. Rul. 9738033*, June 23, 1997 (taxpayer acted reasonably and in good faith and granting of relief did not prejudice government's interest); *Ltr. Rul. 200021013*, February 17, 2000 (same).
9. For partnerships, the rules governing exclusion from gross income under *I.R.C. § 108(a)* and the provisions governing reduction of tax attributes under *I.R.C. § 108(b), (c)*, are applied at the partner level. *I.R.C. § 108(d)(6)*. See *Ltr. Rul. 9619002*, January 31, 1996 (partner's tax consequence determined under *I.R.C. §§ 731, 752*). The income is treated as an item of income allocated separately to each partner pursuant to *I.R.C. § 702(a)*.
    - a. Thus, discharge of indebtedness income is recognized at the partnership level and the *I.R.C. § 108* provisions are applied at the partner level. See *Estate of Newman v. Commissioner*, 934 F.2d 426 (2d Cir. 1991) (insolvency exception to discharge of indebtedness rule applied at partnership level; case arose prior to change in *I.R.C. § 108(d)(6)*); *Murphy v. Commissioner*, 164 F.3d 618 (2d Cir. 1998) (partnership released from debt obligation; partners required to take into account their distributive share of gain); *James R. Brickman, T.C. Memo. 1998-340* (limited partnership's default on note generated discharge of indebtedness income to partners; married taxpayers required to reduce wife's net operating loss carryover to zero because NOLs were community property); *FSA 9999-9999-215, no date given* (discharge of indebtedness with multi-tier partnerships). See also *Kenneth G. Lind, T.C. Memo. 1993-286* (discharge of indebtedness income realized by partnership; neither partner nor partnership was bankrupt or insolvent); *Ltr. Rul. 9815035*, January 7, 1998 (partner granted extension of time to file partnership's election to reduce basis of depreciable property); *Ltr. Rul. 9840026*, June 30, 1998 (partners entitled to exclude discharge of indebtedness income received by partnership which was qualified real property business indebtedness); *CCA FSA Ltr. Rul. 200028019*, April 14, 2000 (no cancellation of indebtedness income for discharge of partnership indebtedness; recourse liability and parties not discharged).
    - b. The election under *I.R.C. § 108(b)(5)* for a bankrupt or insolvent taxpayer to reduce the basis of depreciable property before reducing other tax attributes is made by the partners and not by the partnership. *I.R.C. § 703(b)(1)*.
    - c. Each partner's basis in the partnership is increased by the discharge of indebtedness income allocated to that partner. *I.R.C. § 705(a)(1)(A)*. See *Ltr. Rul. 9739002*, May 19, 1997 (taxpayer's share of discharge of indebtedness excludible from income if taxpayer qualified under *I.R.C. § 108*). This is offset by a decrease in basis (but not below zero) under *I.R.C. § 733*, resulting from the deemed distribution to the partner under *I.R.C. § 752(b)* equal to the partner's share of the reduction in partnership liabilities because of the debt discharge. *Ltr. Rul. 9739002*, May 19, 1997. See *Rev. Rul. 92-97*, 1992-2 C.B. 124.
    - d. If a partner is insolvent, no income is recognized from cancellation of indebtedness and so the partner's share of the cancelled debt does not increase the partner's partnership basis. *Babin v.*

*Commissioner*, 23 F.3d 1032 (6<sup>th</sup> Cir. 1994) (deemed distribution of money from decrease in partnership liabilities exceeded basis and produced gain).

- (1) However, *Babin*, *supra*, does not apply to partnership transactions after 1980. See *Ltr. Rul.* 9739002, May 19, 1997.
  - (2) The partners cannot include in their debt for purposes of an insolvency determination a guarantee of the partnership debt if it is more likely than not that the taxpayers would not have to pay the guarantee. *Dudley B. Merkel*, 109 T.C. 463 (1997) *aff'd*, 192 F.3d 844 (9<sup>th</sup> Cir. 1999) (guarantee was contingent debt).
  - e. If a partnership issues a partnership interest to a creditor in satisfaction of indebtedness, rules similar to those in *I.R.C. § 108(e)(7)* (discussed above for corporations) are to be imposed on creditors of the partnership. *I.R.C. § 108(e)(7)(F)*.
10. The earnings and profits of a corporation are not increased by reason of the discharge of indebtedness to the extent of the amount applied in reduction of basis. *I.R.C. § 312(1)(1)*.
    - a. Earnings and profits apparently are increased to the extent discharge of indebtedness is applied to reduce tax attributes other than basis or is excluded from gross income because tax attributes are exhausted. *Id.*
    - c. If the interest of a shareholder is extinguished or terminated in a bankruptcy “or similar case,” and the corporation has a deficit in earnings and profits, the deficit is reduced by the paid-in capital of the corporation allocable to the interests of the shareholders which have been terminated or extinguished. *I.R.C. § 312(1)(2)*.
  11. The transfer of stock by a sole shareholder of a corporation to a related corporation in return for debt relief has been recharacterized as a stock redemption with a taxable dividend under *I.R.C. § 301*. *Gary D. Combrink*, 117 T.C. No. 8 (2001).

## VI. Income tax consequences of bankruptcy

- A. Upon a filing for bankruptcy, all tax cases and tax collection proceedings are automatically stayed and jurisdiction vests in the bankruptcy court. 11 U.S.C. §§ 362(a)(6), (8), 505(a). See *Ann. 98-89, I.R.B. 1998-40* (revised IRS procedures for handling bankruptcy cases).
  1. Prepetition tax assessments are also stayed, but the statute of limitations on the assessments is suspended during bankruptcy proceedings and 60 days thereafter. *I.R.C. § 6503(i)(1)*.
  2. The statute of limitations on tax collections is suspended during the bankruptcy proceeding and for six months thereafter. 11 U.S.C. § 362(a); *I.R.C. § 6503(b)*.
  3. A taxpayer is precluded from commencing a proceeding in the Tax Court. *Charlotte A. Ash, T.C. Memo. 1989-367*.
    - a. An appeal of a Tax Court decision may also be stayed regardless of which party appeals. *Delpit v. Commissioner*, 18 F.3d 768 (9<sup>th</sup> Cir. 1994) (Chapter 11 filing). But see *Roberts v. Commissioner*, 175 F.3d 889 (11<sup>th</sup> Cir. 1999) (90-day period to file notice of appeal from Tax Court decision not stayed).
    - b. The bankruptcy court may lift the stay to allow a Tax Court hearing to continue. 11 U.S.C. § 362(d).
  4. The stay does not prevent the IRS from issuing a deficiency notice, conducting audits, demanding tax returns, making assessments or issuing a notice and demand for payment. 11 U.S.C. § 362(b)(9).

5. Postpetition tax assessments are allowed. *I.R.C. § 6871(b)*. The bankruptcy stay does not prevent the filing of Tax Court petitions in response to notices of partnership administrative adjustments. *1983 Western Reserve Oil & Gas Co., 95 T.C. 51 (1990), aff'd Unpub. Op. (9<sup>th</sup> Cir. 5/20/93)* (partnership proceedings in Tax Court related to tax liability of individual partners while automatic stays involved only partnership).
  6. If IRS violates the automatic stay, sovereign immunity against suit is waived. *11 U.S.C. § 106*. Punitive damage awards are not permissible against the United States. *11 U.S.C. § 106(a)(3)*.
  7. The IRS position is that bankruptcy discharges do not extinguish discharged tax liabilities; the discharge merely enjoins IRS from collecting against the taxpayer personally. *CC 2001-14, February 23, 2001*.
- B. In the event an individual files for bankruptcy under Chapter 7 (liquidation) or Chapter 11 (reorganization), a new taxpayer is created. *11 U.S.C. § 541(a)*. The bankruptcy estate is a new taxable entity—separate from the individual who had filed for bankruptcy. *I.R.C. § 1398(c)(1)*. Legislation has been introduced to make Chapter 12 bankruptcy filers eligible for new tax entity status. *H.R. 4645, Sec. 2, 105<sup>th</sup> Cong., 2d Sess. (1998)*.
1. The bankruptcy estate includes the property that belonged to the debtor before filing for bankruptcy. The bankruptcy estate also includes—
    - a. Property recovered by the trustee for various reasons including avoidance of liens, fraudulent or preferential transfers and post-petition transactions. *11 U.S.C. § 541(a)(3), (4)*.
    - b. Any inheritance to which the debtor becomes entitled within 180 days after the commencement date. *11 U.S.C. § 541(a)(5)*.
    - c. Rents and profits of the estate. *11 U.S.C. § 541(a)(6)*.
    - d. Property acquired by the estate. *11 U.S.C. § 541(a)(7)*.
  2. The estate usually has income—and incurs expenses—in carrying on the debtor’s operation. At the same time, the debtor may have income from wages earned or property purchased after bankruptcy filing.
    - a. Post-petition payments made by the estate to the debtor for services are deductible by the estate and taxable to the debtor and are not property of the estate.
    - b. Similarly, earnings from off-farm employment by the debtor or spouse are not property of the estate even though such amounts may be reported under local bankruptcy rules.
  3. As a general rule, the bankrupt’s tax year does not change when bankruptcy filing occurs. *I.R.C. § 1398(d)(1)*. However, a debtor with assets other than those that will be exempt may elect to end the debtor’s tax year as of the day before filing for bankruptcy. *I.R.C. § 1398(d)(2)(A), (C)*. This creates two short years for the debtor.
    - a. The first short year ends the day before the bankruptcy filing date; the second year begins with the bankruptcy filing date and ends on the bankrupt’s normal year-end date. *I.R.C. § 1398(d)(2)(A)*. Thus, the taxable year may not end on the last day of a month even though the general rule is that a fiscal year must end on the last day of a month.
    - b. The decision to divide the bankrupt’s tax year is made by election filed by the due date for the return for the first short year. *I.R.C. § 1398(d)(2)(E)*. Thus, the election is made by filing an election by the 15<sup>th</sup> day of the fourth full month after the end of the month bankruptcy is filed. *Temp Treas. Reg. § 7a.2(d). In re Kreidle, 146 Bkrpcy. Rep. 464 (D. Colo. [Bkrpcy.] 1991), aff'd, 91-2 U.S.T.C. ¶ 50371 (D. Colo. 1991)* (in involuntary bankruptcy, case commenced on entry of

order for relief). See also *I.R.S. Pub. 908*.

- (1) The election is made with the filing of the return and can be made without the prior approval of the Internal Revenue Service. *I.R.C. § 1398(d)(2)(A)*.
  - (2) Once made, the election is irrevocable. *I.R.C. § 1398(d)(2)(D)*.
  - (3) The election cannot be made after the tax return has been filed. *I.R.C. § 1398(d)(2)(D)*.
- c. The election is voided if the Chapter 7 or 11 bankruptcy filing is dismissed or is converted to a Chapter 12 or 13 proceeding. *I.R.C. § 1398(b)(1)*. An amended return is to be filed if dismissal or conversion to Chapter 12 or 13 occurs after the filing of the taxpayer's return for the first short year.
  - d. For a debtor who does not elect to close the tax year, any estimated tax payment by the debtor does not become property of the bankruptcy estate. *In re Weir, 90-1 U.S.T.C. ¶ 50,229 (D. Kan. 1990)* (estimated tax payments neither voidable preference nor fraudulent conveyance). See *In re Halle, 91-1 U.S.T.C. ¶ 50,121 (D. Colo. [Bkrpcy.] 1991)* (estimated tax payments made within six weeks of filing bankruptcy not property of bankruptcy estate).
  - e. The bankruptcy estate is entitled to any income tax refund for the period up to bankruptcy filing. *In re Webb, 234 Bkrpcy. Rep. 96 ( W.D. Mo. [Bkrpcy.] 1999)* (debtors filed for Chapter 7 on December 14, 1998; court reduced refund on 1998 return by 17 days which were post-petition).
4. There are several potentially significant features of electing to close the debtor's tax year.
    - a. In that case, the debtor's income tax liability for the first short year is treated as a priority claim against the bankruptcy estate. *11 U.S.C. § 507(a)(6)*. See *In re Mirman, 89-1 U.S.T.C. ¶ 9297 (E.D. Va. 1989)* (debtors individually liable for income taxes for year involuntary bankruptcy filed against them where debtors did not elect to end taxable year as of date of bankruptcy filing).
      - (1) The tax liability involved can be collected from the estate if there are sufficient assets to pay off the estate's debts. If there are not sufficient assets to pay the income tax, the remaining tax liability is not dischargeable. That means the tax can be collected from the debtor later.
      - (2) The income tax owed by the bankrupt for the years ending after the filing is paid by the bankrupt and not by the bankruptcy estate. *Moore v. IRS, 132 Bkrpcy. Rep. 533 (W.D. Pa. [Bkrpcy.] 1991)* (failure to close year; debtor responsible for taxes for year of filing). Thus, closing the bankrupt's tax year can be particularly advantageous if the bankrupt has substantial income in the year before the bankruptcy filing.
    - b. If the taxpayer projects a net operating loss, unused credits or excess deductions for the first short year, in general an election should not be made in the interest of preserving the loss for application against income from the rest of the taxable year. See *Kahle v. Commissioner, T.C. Memo. 1997-91* (debtor did not elect to end tax year with bankruptcy filing; discharge of indebtedness reduced carryover NOLs even though the trustee did not include reduction on bankruptcy estate tax return).
    - c. In general, the election to close the debtor's taxable year should be made if the debtor projects taxable income for the first short year.
      - (1) By filing the election, use can be made by the debtor of any tax attributes to offset taxable income and tax liability.
      - (2) The bankruptcy estate succeeds to tax attributes remaining at commencement of the bankruptcy case. *I.R.C. § 1398(g)*. Tax attributes remaining at the termination of the bankruptcy estate pass back to the debtor.

- (3) To show that the election has been made, “Section 1398 Election” should be printed at the top of the debtor’s first short year return. *Temp. Treas. Reg. § 7a.2(d). Ann. 81-96, May 7, 1981.* A similar statement should be attached to Form 4868, Application for Extension of Time. The income tax return filed for the second short year should be marked “Second Short Period Year Return After § 1398 Election”. *Ann. 81-96, I.R.B. 1981-20, 13.* See generally “*Bankruptcy*,” *IRS Pub. 908.*
- d. For a debtor on the accrual method of accounting, electing to close the tax year requires a closing inventory with any resulting income falling into the short tax year.
- (1) The beginning inventory for the debtor’s short year presumably would be zero.
  - (2) If the debtor does not elect to close the tax year, the debtor’s regular tax year would have a beginning inventory of positive value and an ending inventory reflecting the turn-over of assets to the bankruptcy estate.
  - (3) Unless cash accounting is specifically permitted, the Commissioner may require a shift to accrual accounting by the debtor under I.R.C. § 446 as more nearly reflective of income. *In re BKW Systems, Inc., 90-1 U.S.T.C. ¶ 50,139 (D. N.H. [Bkrpcy.] 1989)* (outcome was additional income for debtor in pre-filing period).
- e. Even if the debtor projects a net operating loss, has unused credits or anticipates excess deductions, the debtor may want to close the tax year as of the day before bankruptcy filing if—
- (1) The debtor likely could not use the amounts.
  - (2) The items could be used by the bankruptcy estate as a carryback to earlier years of the debtor or as a carryforward and,
  - (3) The debtor would likely benefit later from the bankruptcy estate’s use of the loss, deductions or credits. Thus, carrybacks might reduce the debtor’s nondischargeable liability for unpaid taxes.
- f. For state and local tax purposes, the taxable year of an individual debtor terminates automatically upon commencement of the bankruptcy case. *11 U.S.C. §§ 728(a), 1146(a).* Thus, if the debtor does not elect to close the taxable year for federal income tax purposes, the debtor could have different taxable years for federal income tax purposes and for state and local tax purposes.
5. If the debtor does not act to end the tax year, none of the debtor’s income tax liability for the year of bankruptcy filing can be collected from the bankruptcy estate. *In re Mirman, 98 Bkrpcy. Rep. 742 (E.D. Va. [Bkrpcy.] 1989)* (failed to elect to close tax year; entire year’s tax liability rested on debtor); *In re Moore, 132 Bkrpcy. Rep. 533 (W.D. Pa. [Bkrpcy.] 1991)* (same). See *In re Gonzalez, 112 Bkrpcy. Rep. 10 (E.D. Tex. [Bkrpcy.] 1989)* (federal income tax liability from termination of retirement plan was not claim against estate because debtor failed to elect to terminate taxable year). See also *Michael H. Gulley, T.C. Memo. 2000-190* (no short year elected; taxpayer (partner in partnership) not entitled to net operating loss as tax attribute; none of net operating loss remained after reduction by discharge of indebtedness income).
- a. The reason is that the income tax liability for income earned during the year in which bankruptcy occurs accrues after the date of bankruptcy and does not, therefore, become a debt of the estate.
  - b. If the election is not made to close the tax year, the income tax liability for the year of bankruptcy filing becomes a post-petition claim. *In re Moore, 91-2 U.S.T.C. ¶ 50,390 (W.D. Pa. [Bkrpcy.] 1991)* (liability for tax did not arise until after filing when year ended).

### Example

- Alex Brown, a calendar year taxpayer, was pressured by creditors near the end of 1983. In early 1984, Brown sold all 1983 crop corn and soybeans and applied for the corn available under the 1983 payment-in-kind program. On May 1, unable to obtain financing for the 1984 crop year, Brown filed for bankruptcy under Chapter 11. If Brown does not elect two short years, the gain from crop sales (and other income in 1984) would be included as income on Brown's 1984 income tax return. The tax would not be a debt of the bankruptcy estate. If Brown elects two short tax years, income tax deemed to accrue before May 1 would become an obligation of the bankruptcy estate.
6. The selection by the debtor of two short tax years could mean that more self-employment tax will be due. The base income amount (\$80,400 in 2001) is applied in each of the short years. *Rev. Rul. 69-410, 1969-2 C.B. 167*. Thus if the amount of income subject to social security tax (self-employment income plus wage income) exceeds the base amount for the calendar year, more self-employment tax would be levied with two short years rather than remaining with a single tax year. However, as noted above, taxes due for the first short year may be paid as a debt of the bankrupt estate, not the bankruptcy, so any additional self-employment tax may not be a direct concern to the debtor.
  7. An individual who elects to close the taxable year must annualize taxable income for both short years. *I.R.C. § 1398(d)(2)(F)*. It is done in the same manner as for a change in accounting period. See *I.R.C. § 443(a)(1)*.
  8. If the short year is not elected, the tax attributes (including the basis of the debtor's property) pass to the bankruptcy estate as of the beginning of the debtor's tax year; thus, no depreciation may be claimed by the debtor for the period before bankruptcy filing.
  9. A spouse may join in the election to end the taxable year if the debtor and spouse file a joint return for the first short year. *I.R.C. § 1398(d)(2)(B)*. They are not bound to file jointly for the second tax year, however.
    - a. The bankruptcy court can order consolidation of cases filed by a husband and wife. *Bankruptcy Rule 1015(b)*.
    - b. Until consolidated by court order, each estate is entitled to its own personal exemption and standard deduction. *In re Nobel, 167 Bkrpcy. Rep. 436 (W.D. Tex. [Bkrpcy.] 1994)* (Form 1041 properly claimed two personal exemptions and two standard deductions because jointly filed cases still separate entities).
    - c. If the debtor's spouse later files a separate bankruptcy case, the spouse may elect an additional short tax year which commences either with the normal beginning of the year (if the spouse did not elect with the debtor) or with the commencement of the debtor's second tax year (if the spouse joined with the debtor's election). *Temp. Treas. Reg. § 7a.2(f)*. Thus, a spouse who joined in the debtor's election and who elected a short year in the spouse's own bankruptcy case could have three short tax years. See *Temp. Treas. Reg. § 7a.2(g)*.
  10. Additional points:
    - a. First, if a bankruptcy case is later dismissed, the individual debtor is treated as though the bankruptcy petition had never been filed. *I.R.C. § 1398(b)(1)*. See *In re Stahley, 90-1 U.S.T.C. ¶ 50,247 (D. Colo. [Bkrpcy.] 1990)* (gain on sale after dismissal of Chapter 7 petition but before entry of order on court docket taxable to debtor).
    - b. Secondly, a separate entity is not created if a corporation or partnership files for bankruptcy. *I.R.C. § 1399*.
      - (1) A partnership is not treated as an individual but a debtor-partner who is an individual takes the interest in the partnership into account "in the same manner as any other interest of the debtor". *I.R.C. § 1398(b)(2)*.

- (2) There's no separate taxable entity if an individual files under Chapter 12 or 13. *I.R.C. § 1398(a)*. Separate entity status is only for individuals filing under Chapters 7 or 11. See *I.R.C. § 1398(a)*:

“Except as provided in subsection (b), this section shall apply to any case under Chapter 7 (relating to liquidations) or Chapter 11 (relating to reorganizations) of Title 11 of the United States Code in which the debtor is an individual”.

- C. After bankruptcy begins, the gross income of the debtor to which the bankruptcy estate is entitled and income generated by assets required to be included in the bankruptcy estate are included in the bankruptcy estate's income. The gross income of the bankruptcy estate does not include amounts the debtor receives or accrues as income before the beginning of the bankruptcy case.
1. The transfer of assets by the debtor to the bankruptcy estate is not treated as a taxable disposition. *I.R.C. § 1398(f)(1)*. *In re Barden*, 105 F.3d 821 (2d Cir. 1997) (chapter 7 bankruptcy). But see *Matter of Rasmussen*, 95 Bkrpcy. Rep. 657 (W.D. Mo. [Bkrpcy.] 1989) (transfer of assets to bankruptcy estate in Chapter 7 case was taxable exchange with capital gains taxable to debtor). Thus, the transfer does not require income tax to be paid on the gain and does not trigger recapture of depreciation, investment tax credit, land clearing expense, soil and water conservation expense deductions or government cost sharing payments excluded from income. See *Rev. Rul. 90-25, 1990-1 C.B. 10* (obsoleting *Rev. Rul. 74-26, 1974-1 C.B. 7* holding that transfer to bankruptcy trustee was recapture event). Similarly, transfer of an installment contract or other installment obligation is not a taxable transfer. *S. Rep. No. 96-1035, 96<sup>th</sup> Cong., 2d Sess. 29 (1980)*. The estate is treated as the debtor would have been had the debtor not filed for bankruptcy.
    - a. This treatment of nontaxability does not apply if property is transferred directly to creditors. *In the Matter of Brubeck*, 90-1 U.S.T.C. ¶ 50,046 (S.D. Ind. [Bkrpcy.] 1989) *aff'd*, 91-2 U.S.T.C. ¶ 50,364 (S.D. Ind. 1991) (sale of machinery with proceeds applied to FmHA loan prior to filing Ch. 7 bankruptcy); *Ltr. Rul. 8515045, January 11, 1985* (investment tax credit recaptured on transfer of Section 38 property to lender even though bankruptcy filed shortly thereafter).
    - b. *I.R.C. §§ 1245, 1250* were not amended to provide for avoidance of recapture upon transfer of property to the bankruptcy estate. However, the Committee Report to The Bankruptcy Tax Act clearly indicates an intent that the recapture rules not apply. *S. Rep. 1035, 96<sup>th</sup> Cong., 2d Sess. 31 (1980)*.
    - c. For state and local tax purposes, neither gain nor loss is to be recognized on a transfer by operation of law of property from the debtor to the bankruptcy estate or (other than by sale) of property from the estate to the debtor. *11 U.S.C. § 346(g)(1)*.
    - d. In states with a recapturable investment tax credit, *11 U.S.C. § 346(g)(1)* does not protect against recapture as does *§ 1398(f)(1)* for purposes of federal taxes.
    - e. For purposes of state and local taxes, any income of the bankruptcy estate is taxed to the bankruptcy estate as an estate, not as an individual under the federal rules. *11 U.S.C. § 346(b)(2)*.
    - f. If the bankruptcy estate is entitled to a salary payment or other amount earned by the debtor before bankruptcy filing, as would normally occur because the right to receive payment passes to the bankruptcy estate, the amount of the payment is included in the estate's gross income and not the debtor's gross income. *S. Rep. 96-833, 96<sup>th</sup> Cong., 2d Sess. 26 (1980)*. For state and local tax purposes, the applicable provision does not override assignment of income principles, however. See *11 U.S.C. § 346(b)(1)*.
    - g. Any gain on sale of partially exempt assets (such as a homestead in some states with a maximum exemption level) is the liability of the bankruptcy estate where the residence is sold by the bankruptcy trustee. *Ltr. Rul. 9122042, March 4, 1991*. See *Ltr. Rul. 9017075, January 31, 1990* (issue under reconsideration and later revoked).

- h. If the residence is exempt and reverts in the debtor, the debtor is liable for income tax on gain from later sale of the residence. *Ltr. Rul. 9122042, March 4, 1991.*
  - i. The courts have been divided on whether a bankruptcy trustee can elect to exclude gain on sale of the residence. Some have denied the exclusion. *In re Barden, 105 F.3d 821 (2d Cir. 1997)* (chapter 7 bankruptcy; not allowed to use exclusion); *In re Manfred Mehr, 93-1 U.S.T.C. ¶ 50,091 (D. N.J. [Bkrpcy.] 1993)*; *In re Winch, 226 Bkrpcy. Rep. 591 (S.D. Ohio [Bkrpcy.] 1998)*. However, several courts have allowed the exclusion as amended in 1997. *In re Kerr, 99-1 U.S.T.C. ¶ 50,310 (W.D. Wash. 1999)*; *In re Popa, 98-1 U.S.T.C. ¶ 50,276 (N.D. Ill. [Bkrpcy.] 1998)* (bankruptcy estate treated as debtor would have been treated under I.R.C. § 1398); *In re Munster, 226 Bkrpcy. Rep. 632 (E.D. Mo. [Bkrpcy.] 1998)*; *In re Bradley, 1998 WL 400737, appeal pending, MD. Tenn.*; *In re Godwin, 99-1 U.S.T.C. ¶ 50,287 (S.D. Ohio [Bkrpcy.] 1999)*; *In re Curran, 99-2 U.S.T.C. ¶ 50,742 (N.D. Ga. [Bkrpcy.] 1999)*. IRS has conceded the issue. *Chief Counsel Notice (35)-000-162, August 10, 1999.*
  - j. The bankruptcy estate succeeds to any earned income credit. *In re Richardson, 98-1 U.S.T.C. ¶ 50,190 (S.D. Ohio [Bkrpcy.] 1997)*; *In re George, 199 Bkrpcy. Rep. 60 (N.D. Okla. [Bkrpcy.] 1998)* (earned income tax credit exempt under state law); *In re Goertz, 202 Bkrpcy. Rep. 614 (W.D. Mo. 1998)* (not exempt from creditors under state law). See Part One.
2. The estate claims deductions and credits in the same manner as if the debtor had continued in the same business. *I.R.C. § 1398(e)(3).*
- a. Apparently, recaptured investment tax credit on disposition of assets by the bankruptcy estate is the responsibility of the bankruptcy estate. See *I.R.C. § 1398(f)(1)* (on transfer of assets to the bankruptcy estate, “the estate should be treated as the debtor would be treated with respect to such asset”).
    - (1) In other settings, recaptured investment tax credit is the responsibility of whomever received the benefit from claiming the credit. See *Treas. Reg. § 1.47-3(f)(6)* (tax-free exchange to corporation followed by corporate disposition of assets). But see *In re Higgins, 29 Bkrpcy. Rep. 196 (N.D. Iowa [Bkrpcy.] 1983)* (investment tax credit recapture on liquidation of bankruptcy estate’s property by trustee held to be revival of prepetition income tax liability of debtor);
    - (2) If the investment tax credit property is not part of the bankruptcy estate, the debtor is liable for the recapture tax. *Jerry L. Moudy, T.C. Memo. 1990-169* (debtor as partner owned stock in corporation which had acquired investment tax credit property from debtor’s partnership in tax-free exchange; repossession of corporation’s property by creditors triggered recapture).
    - (3) The Congressional Reports indicate that the outcome in *Higgins* was rejected in the legislation. *S. Rep. 1106, 95<sup>th</sup> Cong., 2d Sess. 18 (1978)*. See *Hartung, “The Liability of an Individual Debtor for Taxes Incurred by the Bankruptcy Estate”, 9 J. Agr. Tax’n & L. 64, 72-73 (1987)*.
    - (4) IRS has obsoleted *Rev. Rul. 74-26, 1974-1 C.B. 7*, holding that transfer of investment tax credit property to a bankruptcy estate causes recapture. *Rev. Rul. 90-25, 1990-1 C.B. 10*.
  - b. In general, the determination of whether any amount paid or incurred by the bankruptcy estate is allowable as a deduction or credit is made as if the amount were paid or incurred by the debtor and as if the debtor were engaged in the same trade, business and activity as before commencement of the bankruptcy case. *I.R.C. § 1398(e)(3).*
    - (1) Bankruptcy fees (legal, accounting and trustee’s fees) may be deductible to the extent the fees are proximately related to the business involved. *Patrick Catalano, T.C. Memo. 2000-82*

(93.79 percent of fees deductible by debtor). See *Herbert E. Cox, T.C. Memo. 1981-552* (part of legal fee allocable to failed business deductible based on ratio of creditors' claims).

- (2) The Chief Counsel's Office has ruled that deductions for expenses that would not have been incurred had the property not been held by a bankruptcy estate are allowable from gross income (deducted "above the line"). *CCA Ltr. Rul. 200136004, May 17, 2001* (reference to I.R.C. § 67(e) for trusts and estates but a bankruptcy estate is neither a trust nor an estate). See *In re Miller, 252 Bkrpcy. Rep. 110 (E.D. Tex. [Bkrpcy.] 2000)* (no reason exists to render the I.R.C. § 67(e) exception inapplicable to administrative expenses associated with bankruptcy estates).
  - (3) Amounts paid to the debtor as a family allowance or "draw" are deductible by the estate and taxable to the debtor. See *I.R.C. § 1398(h)(1)*. Amounts paid to a sole proprietor as debtor in possession are not considered wages. *Ltr. Rul. 8728056, April 15, 1987*. Apparently, such amounts are self-employment income, at least to the extent of net farm or business income.
  - (4) To the extent the farm operation shows a net profit, amounts paid to a sole proprietor debtor are subject to self-employment tax. *I.R.C. § 1401*.
  - (5) It would appear that amounts paid to the debtor's children under age 18 would be protected from employment tax.
- c. After notice and a hearing, the bankruptcy court may award reasonable compensation for actual, necessary professional services rendered. See *11 U.S.C. § 330(a)(1)*. Pre-filing fees paid would seem not to be deductible by the estate.
  - d. An accrual basis debtor should be entitled to deduct expenses accrued before bankruptcy even if the expense amount is paid by the bankruptcy estate. Because the estate takes over the debtor's method of accounting, the estate of an accrual basis debtor may not claim a deduction for an expense paid by the estate but accrued before bankruptcy by the debtor. See *I.R.C. § 1398(g)(7)*.
  - e. For state and local tax purposes—
    - (1) A deduction with respect to a liability may not be allowed for any taxable period during or after which the liability is forgiven or discharged. *11 U.S.C. § 346(j)(2)*. A deduction with respect to a liability includes a capital loss incurred on the disposition of a capital asset with respect to a liability incurred in connection with the acquisition of the asset. *Id.*
    - (2) An accrual basis debtor is not permitted to claim a deduction for a liability that is subsequently discharged in a bankruptcy proceeding. *Id.* An amended return may be necessary if the accrual basis debtor has already filed the return for the period.
3. Expenses of administering the bankrupt estate are also deductible. *I.R.C. § 1398(h)(1)*.
    - a. A bankruptcy estate is permitted to deduct administrative expenses on a three year carryback and a seven year carryforward basis. *I.R.C. § 1398(h)(2)*. This is important because, in general, only trade or business expenses may be included in a net operating loss calculation. See *I.R.C. § 172(d)(4)*.
    - b. The carryback/carryforward rules involve calculation of an administrative expense loss for the year which consists of unused deductions not includible in the net operating loss of the bankruptcy estate because the deductions are not attributable to the taxpayer's trade or business and exceed income not derived from a trade or business. See *I.R.C. § 1398(h)(2)(B)*.
    - c. The amount of the administrative expense loss which may be carried to a year other than the year in which the loss is incurred is determined under *I.R.C. § 172(b)(2)*. See *I.R.C. § 1398(h)(2)(C)*.

Thus, a loss is carried first to the earliest taxable year to which it may be carried and then to succeeding taxable years. See *I.R.C. § 172(b)(2)*.

- d. However, administrative expense losses may not be carried back to taxable years of the debtor ending before commencement of the case. See *I.R.C. § 1398(j)(2)(c)(i)*.
  - e. Administrative expense losses remaining at the termination of the case do not pass to the debtor. See *I.R.C. §§ 1398(h)(2)(D), 1398(i)*.
  - f. Net operating loss carrybacks and carryforwards are to be applied against income of the estate (and are to be reduced) before administrative expense loss carrybacks and carryforwards. See *I.R.C. § 1398(h)(2)(c)*.
  - g. Federal income taxes are not allowed as a deductible administrative expense even though allowable under the bankruptcy act as an administrative expense. See *I.R.C. § 275*.
  - h. For corporations undergoing reorganization in bankruptcy, the ordinary and necessary business expenses are deductible by the corporation but costs and expenses incurred with respect to the reorganization proceeding must be capitalized because the corporation would be benefited in future years. *Rev. Rul. 77-204, 1977-2 C.B. 40*. For corporations in bankruptcy liquidation, the liquidation costs may be deducted as trade or business expenses except for costs connected with the sale of assets which are to be used to offset gain. *Id.* See *In re Placid Oil Co., 92-1 U.S.T.C. ¶ 50,051 (N.D. Tex. 1991), rev'd & rem'd, 988 F.2d 554 (5<sup>th</sup> Cir. 1993)* (professional fees and expenses related to particular asset or debt transaction are nondeductible capital expenditures; professional fees and expenses for initiating and administering bankruptcy proceedings are deductible).
  - i. Administrative expenses of a bankruptcy estate are deductible on the estate's final income tax return without regard to the two percent limitation (of adjusted gross income). *In re Miller, 2001-1 U.S.T.C. ¶ 50,137 (E.D. Tax. [Bkrpcy.] 2000)* (bankruptcy estate is "estate" for purposes of *I.R.C. § 67(e)*).
  - j. For purposes of state and local taxes, administrative expenses are deductible as business expense. *11 U.S.C. § 346(e)*. Thus, for state and local tax purposes, administrative expenses enter into net operating loss calculations with any net operating loss carried back to pre-bankruptcy taxable years of the debtor and with the debtor succeeding to any remaining net operating loss at the termination of the case.
4. The bankruptcy estate is allowed to use one personal exemption, individual deductions, the basic standard deduction and tax rates for a married taxpayer filing separately. *I.R.C. § 1398(c)*. Before 1987, the reference was to the zero bracket amount rather than the basic standard deduction.
    - a. A bankruptcy estate was apparently not eligible for income averaging (before 1987). See *I.R.C. § 1303(a)* (bankruptcy estate not an individual). The same is likely under the current version of income averaging. *I.R.C. § 1301*.
    - b. The bankruptcy estate uses the debtor's method of accounting. *I.R.C. § 1398(g)(7)*. However, IRS may require a shift in method of accounting to more accurately reflect income. *In re BKW Systems, Inc., 90-1 U.S.T.C. ¶ 50,139 (D. N.H. [Bkrpcy.] 1989)* (shift to accrual accounting resulted in additional income for debtor in pre-bankruptcy filing period).
    - c. Accounting period—
      - (1) On the first income tax return, the bankruptcy estate as a new taxpayer may adopt any taxable year without approval for computing taxable income. *Treas. Reg. § 1.441-1(b)(3)*.

- (2) The taxable year may be for the calendar year or a fiscal year of 12 months ending on the last day of a month other than December with the initial period being not more than 12 months. *I.R.C. § 441(a)*.
  - (3) If the taxpayer is not in existence for the full year, a short-year return may be filed. See *I.R.C. § 443(a)(2)*. Income for the short year need not be annualized and the full personal exemption and standard deduction amounts are allowed. *I.R.C. § 443(a)(2),(c)*.
  - (4) A bankruptcy estate may change the annual accounting period once without Internal Revenue Service approval. *I.R.C. § 1398(j)(1)*.
    - (a) Income is apparently placed on an annualized basis in accordance with a prescribed formula. However, it is arguable that annualization is not required where a bankruptcy trustee changes the estate's taxable year. That is because the Secretary's approval is not required and, therefore, *I.R.C. § 443(b)(1)* arguably would not apply.
    - (b) ACRS cost recovery is allocated to the debtor's return according to the number of months and part months in the short year divided by 12 except for 19 year real property placed in service or disposed of in the short period taxable year. *Prop. Treas. Reg. § 1.168-2(f)*. The month of bankruptcy filing is omitted from the first short year. *Prop. Treas. Reg. § 1.168-2(f)(5)*.
5. An income tax return, Form 1041, must be filed by the trustee in bankruptcy or debtor in possession if the estate's gross income was \$2700 or more for years before 1987. *I.R.C. §§ 6012(a)(9), 6012(b)(4)* (for Chapter 7 or 11 bankruptcy, returns are to be filed by the fiduciary). See *In re Pizza Pronto, Inc., 970 F.2d 783 (11<sup>th</sup> Cir. 1992)* (chapter 7 liquidating trustee required to file income tax return for bankruptcy estate).
- a. The filing level is set equal to the exemption amount plus the basic standard deduction under *I.R.C. § 63(c)(2)(D)*. See *In re Nobel, 167 Bkrpcy. Rep. 436 (W.D. Tex. [Bkrpcy.] 1994)* (in husband-wife unconsolidated joint case, estate allowed two standard deductions and two personal exemptions).
    - (1) For tax years beginning in 2000, the figure is \$6,475. *Rev. Proc. 99-42, I.R.B. 1999-46*.
    - (2) The duty on the part of trustees to file an income tax return existed prior to enactment of the Bankruptcy Tax Act of 1980. *In re Joplin, 882 F.2d 1507 (10<sup>th</sup> Cir. 1989)*. Compare *In re Farrell, 99-1 U.S.T.C. ¶ 50,499 (M.D. Pa. [Bkrpcy.] 1999)* (bankruptcy trustee lacked authority to compel debtor to file tax returns; government failed to prove returns "required or appropriate").
    - (3) In a questionable decision, the Bankruptcy Court has held that an income tax return was not required where substantial discharge of indebtedness income had been incurred but was not required to be taken into account because of insolvency and the remaining income was less than the personal exemption plus the standard deduction. *In re Pflug, 146 Bkrpcy. Rep. 687 (E.D. Va. [Bkrpcy.] 1992)*.
  - b. A debtor in possession is to perform all functions and duties of a trustee. *11 U.S.C. § 1107(a)*.
  - c. Because *I.R.C. § 1398(c)* requires the bankruptcy estate's taxable income to be calculated on the basis of a married individual filing a separate return, the trustee may file a Form 1040 as a supporting schedule to show income, deductions, exemptions and credits. *I.R.S. Pub. 908*. See *Ann. 81-96, I.R.B. 1981-20, 13*.
  - d. Trustees and their advisors are cautioned that alternative minimum tax is applicable to bankruptcy estates. Legislation has been introduced to make the 90 percent limitations of *I.R.C. § 56(d)*

inapplicable to estates in Chapter 7 bankruptcy. *H.R. 4295, 106<sup>th</sup> Cong., 2d Sess. (2000)*.

- e. A trustee in bankruptcy has no personal liability for federal taxes owed by the bankruptcy estate. *31 U.S.C. § 3713(b)*. Compare *CCA Ltr. Rul. 200036043, May 17, 2000* (Chapter 11 trustee could be held personally liable for communication excise taxes under *I.R.C. § 6672*). Other fiduciaries bear personal liability for payment of tax due. See, e.g., *David Shawn Beckwith, T.C. Memo. 1995-20* (co-executor who distributed assets of estate before payment of tax liable for tax; co-executor also subject to transferee liability as beneficiary); *In the Matter of Ulrich, 01-2 U.S.T.C. ¶ 60,413 (E.D. La. 2001)* (executor personally liable under *31 U.S.C. § 3713(b)* because 10-year collection period had not expired). *But see William D. Little, 113 T.C. No. 31 (1999)* (estate representative of decedent not personally liable even though IRS not paid; told repeatedly by estate's attorney there were no tax liabilities).
- (1) A trustee appointed to liquidate and distribute property as part of a bankruptcy reorganization plan is required to pay taxes on income attributable to the debtor's property. See *In re Holywell Corp., 503 U.S. 47 (1992)* (trustee of liquidating trust established by Chapter 11 plan responsible for payment of federal tax on gain realized from sale of trust assets under plan because trust was grantor trust and not separate entity and trustee not Chapter 11 trustee). See also *In re Holywell Corp. & Subs., 00-2 U.S.T.C. ¶ 50,710 (4<sup>th</sup> Cir. 2000)* (bankruptcy court's resolution of bankruptcy trustee's liability not abuse of discretion). The bankruptcy court has the authority to appoint an accountant to file income tax returns for a bankruptcy estate in a Chapter 7 proceeding. *In re Pizza Pronto, Inc., 970 F.2d 783 (11<sup>th</sup> Cir. 1992)*.
- (2) See *31 U.S.C. § 3713*:
- “(a) (1 A claim of the United States Government shall be paid first when—
- “(A) a person indebted to the Government is insolvent and—
- “(i) the debtor without enough property to pay all debts makes a voluntary assignment of property; or
- “(ii) property of the debtor, if absent, is attached; or
- “(iii) an act of bankruptcy is committed; or
- “(B) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.
- “(2) This subsection does not apply to a case under title 11.
- “(b) A representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government”.
- (3) Trustees may be excused from filing income tax returns if records are not available for reasons beyond the control of the trustee. *In re Molnick's, Inc., 95-1 U.S.T.C. ¶ 50,209 (C.D. Calif. 1995)* (records seized by parties to litigation).
- (4) Federal agencies are entitled to priority under the statute but federally-related agencies such as FDIC are not eligible for a priority position. *Lapadula & Villani, Inc. v. United States, 563 F. Supp. 782 (S.D. N.Y. 1983)* (liquidation outside bankruptcy).
- (5) If a bankruptcy trustee makes mistakes in preparing an estate's tax return, the trustee is personally liable only if guilty of gross negligence. *Dodson v. Huff, No. 99-50205 (5<sup>th</sup> Cir. 2000)*.

- f. Although trustees in bankruptcy and debtors in possession are to give notice in writing of qualification to the Internal Revenue Service within 10 days of appointment (or authorization to act), *I.R.C. § 6036* (notice required of all receivers, trustees in bankruptcy, assignees for benefit of creditors “or other like fiduciary”), after January 29, 1988, the requirement has been eliminated under the treasury regulations because the notice requirements under the Bankruptcy Rules were found sufficient. *Treas. Reg. § 301.6036-1(a)(1)*, amended by *T.D. 8172, 53 Fed. Reg. 2599 (January 29, 1988)*.
- (1) Notice was to be given to—
 

Office of District Director Internal Revenue Service

ATTN: Chief of Special Procedures Section
  - (2) Notice did not need to be given if prior to, on or within 10 days of appointment or authorization to act a notice had been given under the Bankruptcy Act to the Secretary of the Treasury “or other proper officer of the Treasury Department”. *Treas. Reg. § 301.6036-1(a)(1)*.
  - (3) The notice was to contain—
    - (a) The name and address of the person making the notice and the date of appointment or the taking of possession of the assets of the debtor or other person whose assets are controlled.
    - (b) The name, address and taxpayer identification number of the debtor or other person whose assets are controlled.
    - (c) In the case of a court proceeding—
      - [1] The name and location of the court in which the proceedings are pending.
      - [2] The date proceedings were instituted.
      - [3] The number under which the proceedings are docketed, and
      - [4] When possible, the date, time and place of any hearing, meeting of creditors or other scheduled action with respect to the proceedings. *Treas. Reg. § 301.6036-1(a)(4)(i)*.
  - (4) The notice required by *I.R.C. § 6036* met the requirements of the notice required by *I.R.C. § 6903* (notice that a fiduciary has the powers, rights, duties and privileges of taxpayer).
    - (a) If notice is not filed, a Notice of Deficiency given to taxpayer, transferee or other person subject to liability is valid.
    - (b) The statute of limitations on assessments is suspended from the date a bankruptcy case is filed until 30 days after notice is given but not more than two years. *I.R.C. § 6872*.
- g. The trustee in bankruptcy is responsible for obtaining an employer identification number for the estate for use in filing tax returns. To obtain, file Form SS-4, “Application for Employer Identification Number”.
- h. The trustee or debtor in possession must withhold income tax (where required) and social security tax and file employment tax returns for wages paid by the trustee or debtor in possession. If not paid, the trustee or debtor may be liable for payment.

- i. The trustee has the duty to prepare and file Form W-2, Wage and Tax Statement, for wage claims paid by the trustee, whether the claims accrued before or during bankruptcy.
6. A trustee may request a determination of any unpaid tax liability of the bankruptcy estate (for any tax incurred during administration of the bankruptcy estate) by filing a return and a request for prompt determination with the District Director for the district in which the case is pending. *11 U.S.C. § 505(b)*.

- a. A copy of the return or returns filed by the bankruptcy trustee or debtor in possession and a statement of the name and location of the office where the returns were filed (usually the regional service center) is to be enclosed. See *Rev. Proc. 81-17, 1981-1 C.B. 688*. The envelope must be marked—

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- b. Unless there is fraud or material misrepresentation in the return, the trustee, the debtor and any successor to the debtor are discharged from liability for the tax—
    - (1) Upon payment of the tax shown on the return if there is no notification of an audit within 60 days of the request or the Internal Revenue Service does not complete an audit and notify the fiduciary of tax due within 180 days after the request or within additional time permitted by a court;
    - (2) Upon payment of tax determined by a court after audit and dispute of tax; or
    - (3) Upon payment of tax determined by audit. *11 U.S.C. § 505(b)*.
  - c. The Tax Court has held that the 60-day tax clearance may discharge the trustee from liability for taxes, but not the bankruptcy estate. *In re Rode, 119 Bkrpcy. Rep. 697 (E.D. Mo. [Bkrpcy.] 1990)*. *In re Fondiller, 125 Bkrpcy. Rep. 805 (N.D. Calif. 1991)* (trustee filed request for prompt tax liability determination with bankruptcy estate tax returns and IRS did not respond within 60 days but later assessed deficiencies against estate; court held that Section 505(b) did not discharge bankruptcy estate as successor of debtor from liability for taxes); *In re West Texas Marketing Corp., 155 Bkrpcy. Rep. 399 (N.D. Tex. [Bkrpcy.] 1993)* (same).
7. The individual debtor files a return for the tax year on Form 1040.
- a. If the debtor elects to end the tax year on the day before the date of bankruptcy filing, a first short year return must be filed as noted above.
  - b. A separate Form 1040 must be filed for the second short year by the regular due date. The second short year return should be marked, “Second Short Year After Section 1398 Election”.
  - c. If a bankruptcy case is dismissed or converted to Chapter 12 or 13, the Internal Revenue Service Center should be notified with an amended return to substitute for any full or short year returns filed by the debtor and any returns filed by the bankruptcy estate.
8. Disclosure of returns—
- a. The trustee is entitled to disclosure of an individual debtor’s tax returns for the taxable year in which the case was commenced and prior taxable years. *I.R.C. § 6103(e)(5)*.
  - b. The debtor is entitled to disclosure of returns of the estate. *Id.*
  - c. However, the disclosure of the debtor’s returns to the trustee is not required in involuntary cases

until the order for relief has been entered unless the court finds that disclosure is appropriate for purposes of determining whether an order for relief should be entered.

- D. The bankruptcy estate, for most purposes, steps into the shoes of the debtor and succeeds to the following items of the debtor—
1. The net operating loss carryovers under I.R.C. § 172. *I.R.C. § 1398(j)(2)(A)*. However, if the bankruptcy estate is terminated after a debtor dies, the surviving spouse may not use unused net operating losses to which the bankruptcy estate succeeded. *FSA Ltr. Rul. 200118003, December 26, 2000* (only taxpayer who sustains loss can use it).
    - a. For purposes of determining the number of years to which a net operating loss or a capital loss may be carried forward, presumably the last taxable year of a taxpayer (whether or not a short taxable year) and the first taxable year of the succeeding taxpayer each constitute a taxable year. *Cf. Treas. Reg § 1.172-4(b)(3)*.
    - b. The limitations period for tax loss refunds is not tolled while the bankruptcy case is open. I.R.C. § 6511 takes precedence over 11 U.S.C. § 346(i) in determining which statute of limitations to apply. *In re Eric T. Page, 94-2 U.S.T.C. ¶ 50,541 (D. Kan. [Bkrpcy.] 1994)*.
    - c. Before the enactment of the Bankruptcy Tax Act of 1980, the bankruptcy estate did not succeed to the net operating losses of the debtors. *In re Luster, 981 F.2d 277 (7<sup>th</sup> Cir. 1992)* (net operating loss carryforwards were not property of bankruptcy estate).
  2. The carryover of excess charitable contributions under I.R.C. § 170(d)(1).
  3. Any recovery exclusions under I.R.C. § 111 relating to recovery of bad debts, prior taxes and delinquency amounts.
  4. The carryovers of any credit and all other items which, but for commencement of the bankruptcy case, would be required to be taken into account by the debtor with respect to any credit. See *In the Matter of Davis, 92-1 U.S.T.C. ¶ 50,096 (S.D. Iowa [Bkrpcy.] 1991)* (earned income credit part of debtor's bankruptcy estate; credit held exempt).
  5. The capital loss carryover under I.R.C. § 1212.
  6. For assets acquired from the debtor (other than by sale or exchange) the basis, holding period and "character it had in the hands of the debtor".
  7. The method of accounting used by the debtor.
  8. Other tax attributes as announced by regulation. Regulations have been issued which provide for transfer of two additional tax attributes of the debtor —
    - a. The debtor's unused passive activity loss and unused passive activity credit (determined as of the first day of the debtor's tax year in which the bankruptcy case commences) pass to the bankruptcy estate beginning with its first tax year. *Treas. Reg. § 1.1398-1(c)*. See *In re Antonelli, 150 Bkrpcy. Rep. 364 (D. Md. [Bkrpcy.] 1992)*, *aff'd, 92-2 U.S.T.C. ¶ 50,619 (D. Md. 1992)* (debtor's pre-petition passive activity losses did not pass to bankruptcy estate before issuance of temporary regulations; court refused to consider passive activity losses as so closely related to net operating losses and capital losses as to be included); *In re Rueter, 93-2 U.S.T.C. ¶ 50,642 (N.D. Calif. 1993)* (debtors and not bankruptcy estate were sole owners of right to carry forward pre-petition passive activity losses).

- b. The debtor's unused disallowed losses under the at-risk rules, determined as of the first day of the debtor's year in which the case commences, pass to the bankruptcy estate beginning with its first tax year. *Treas. Reg. § 1.1398-2(c)*.
  - c. The regulations are generally effective for bankruptcy cases commencing on or after November 9, 1992 and are applicable to cases commencing earlier and terminating after that date if the debtor and estate jointly and irrevocably elect to apply the regulations. *Treas. Reg. § 1.1398-1(f)(2)(vi),-2(f)(2)(vi)*.
9. The bankruptcy estate apparently takes over the debtor's age and thus is liable for premature distribution penalty taxes for distributions from retirement plans. *In re Kochell*, 804 F.2d 84 (7<sup>th</sup> Cir. 1986), *rev'g*, 55 *Bkrpcy. Rep.* 380 (W.D. Wis. 1985), *aff'g*, 53 *Bkrpcy. Rep.* 250 (W.D. Wis. [Bkrpcy.] 1985) (Individual Retirement Account not exempt under 11 U.S.C. § 522(d)(10)(E); bankruptcy estate liable for premature distribution penalty). Compare *Jerry Larotonda*, 89 T.C. 287 (1987) (IRS levy on taxpayer's Keogh account for back taxes resulted in income tax on amount levied).
10. The bankruptcy estate also succeeds to similar state and local tax items. 11 U.S.C. § 346(i)(1)(c).
- a. Investment tax credit.
  - b. Any recovery exclusion.
  - c. Any loss carryover.
  - d. Any foreign tax credit carryover.
  - e. Any capital loss carryover.
  - f. Any claim of right.
11. Also, it has been unclear whether the bankruptcy estate succeeds to the exclusion for gain on the sale of the residence. Some courts have denied the exclusion. *In re Barden*, 105 F.3d 821 (2d Cir. 1997) (Chapter 7 bankruptcy); *In re Manfred Mehr*, 93-1 U.S.T.C. ¶ 50,091 (D. N.J. [Bkrpcy.] 1993 (Chapter 7 bankruptcy)). However, several courts have allowed the exclusion as amended in 1997. E.g., *In re Popa*, 98-1 U.S.T.C. ¶ 50,276 (N.D. Ill. [Bkrpcy.] 1998). IRS has conceded the issue.
- E. Relationship of debtor to estate at end of bankruptcy proceeding—
1. The debtor succeeds to the following tax attributes of the bankruptcy estate—
- a. Net operating loss carryovers. See *John M. Schaefer*, T.C. Memo. 1998-163 (no tax return filed by bankruptcy estate and no documentary evidence of net operating loss; no deduction allowed); *Allen C. Chamberlin*, T.C. Memo. 2000-50 (carryover losses absorbed in bankruptcy estate from sale of personal residence; no losses available to debtor after bankruptcy estate terminated).
  - b. Charitable contributions carryover.
  - c. Any recovery exclusion under I.R.C. § 111 relating to recovery of bad debts, prior taxes and delinquency amounts.
  - d. The carryover of any credit.
  - e. Capital loss carryover.
  - f. The income tax basis, holding period and character of assets in the hands of the bankruptcy estate. *I.R.C. § 1398(i)*.

2. Note that the debtor does not succeed to the estate's method of accounting. *I.R.C. § 1398(i)*.
3. Thus, if a bankruptcy estate generates a net operating loss, the loss can be carried back to the estate's earlier tax years and, as to losses remaining at the end of the bankruptcy proceedings, even to tax years of the individual debtor before the bankruptcy petition was filed. *I.R.C. § 1398(j)(2)*. The same treatment applies to investment tax credit and other credits that can be carried back.
  - a. A bankruptcy estate is, of course, subject to the usual rules on the number of years losses and credits can be carried back and forward.
  - b. The debtor cannot carry back net operating losses for tax years after the bankruptcy petition was filed to tax years before the filing. Again, the same rule applies to investment tax credit and other credits. If a carryback were possible, any refunds would become property of the bankruptcy estate which would interfere with the debtor's fresh start.
  - c. If the bankruptcy estate incurs a net operating loss, the estate can carry the loss back not only to its own earlier tax years but also to those of the debtor before the tax year in which the bankruptcy case began. *I.R.C. § 1398(j)(2)*. See *Ltr. Rul. 8932002, April 19, 1989* (alternative tax net operating loss could be carried back similarly).
    - (1) Likewise, the estate may carry back excess credits to pre-bankruptcy years of the individual debtor. *I.R.C. § 1398(j)(2)(A)*.
    - (2) If a carryback to a pre-bankruptcy year of the debtor results in a refund, the refund is property of the bankruptcy estate. Cf. *Segal v. Rochelle, 382 U.S. 375 (1966)* (tax refund attributable to carryback of net operating losses of estate to pre-bankruptcy years of debtor is an interest in property acquired by estate after commencement of case).
  - d. A trustee in bankruptcy can revoke a debtor's net operating loss carryforward election without approval of IRS even though such elections are irrevocable. *In re Russell, 927 F.2d 413 (8<sup>th</sup> Cir. 1991)* (bankruptcy trustee filed amended returns with net operating losses carried back, entitling bankruptcy estate to refund). On remand, the Bankruptcy Court held that the prepetition net operating loss election was not made with intent to defraud creditors. *In re Russell, 93-1 U.S.T.C. ¶ 50,309 (W.D. Ark. 1993)*. See *In re Feiler, 230 Bkrpcy. Rep. 164 (9<sup>th</sup> Cir. [Bkrpcy.] 1999)*, *aff'd, 218 F.3d 948 (9<sup>th</sup> Cir. 2000)* (NOL election could be avoided by trustee in favor of allowing NOLs to be carried back to earlier tax years; NOLs are an interest in property of debtor).
  - e. A debtor apparently succeeds to passive activity losses of the bankruptcy estate as of the first day of the bankruptcy estate's taxable year in which the transfer occurs. *Ltr. Rul. 9611028, December 14, 1995*.
  - f. For state and local tax purposes, the estate may carry back any loss of the estate to a taxable period of the debtor ending before the order for relief in the same manner as the debtor could have carried back the loss had the loss been incurred by the debtor. *11 U.S.C. § 346(i)(3)*. However, in determining the number of taxable periods during which the estate may use a loss carryback, the taxable year of the debtor during which the case is commenced is deemed not to have been terminated by commencement of the case. *11 U.S.C. § 346(h)*. Therefore, for state and local tax purposes, the debtor's short taxable year in which the case was commenced does not count for carryback purposes.
  - g. For state and local tax purposes, debtors may apparently carry back post bankruptcy losses to pre-bankruptcy years after the close of the bankruptcy case. See *11 U.S.C. § 346(i)(3)*. This is not possible for federal income tax purposes as noted above.
4. For state and local tax purposes, a debtor may use tax attributes of the estate to which the debtor succeeds as though any applicable time limitations on such use were suspended during the time the

- case is pending. *I.R.C. § 346(i)(2)*. Thus, the years during which the bankruptcy estate is in existence are not counted for purposes of determining the number of years the debtor can use carryovers returning to the debtor from the estate. There is no comparable provision for federal income tax purposes.
- F. Income tax generated on sale or disposition of property by the bankruptcy estate is a liability of the bankruptcy estate and is paid as an administrative expense. *I.R.C. § 6012(a)(9)*. See *In re Wills*, 46 *Bkrpcy. Rep.* 333 (D. Md. 1985). If the bankruptcy case is dismissed, any tax consequences devolve upon the debtor. *In re Stahley*, 90-1 *U.S.T.C.* ¶ 50,247 (D. Colo. [*Bkrpcy.*] 1990) (farm machinery sold after court order dismissing case but before filed).
1. If insufficient assets are available to pay the tax, any tax remaining does not return to the debtor. *In re Lambdin*, 33 *Bkrpcy. Rep.* 11 (M.D. Tenn. [*Bkrpcy.*] 1983) (unpaid administrative expense does not become obligation of debtor); *In re DUBY*, 98 *Bkrpcy. Rep.* 126 (D. R.I. [*Bkrpcy.*] 1989) (capital gains tax paid as administrative expense). But see *In re Stine*, 81 *Bkrpcy. Rep.* 641 (N.D. Fla. [*Bkrpcy.*] 1988) (debtor personally liable for post-petition interest on pre-petition tax claim even though tax claim paid by bankruptcy estate).
    - a. The Internal Revenue Manual has been revised to state that no penalties under I.R.C. § 6651, 6654 or 6655 are to be assessed under I.R.C. § 6658 for failure to timely pay tax during the pendency of a bankruptcy case if the tax was incurred by the bankruptcy estate and the failure to pay occurred under a court order finding that there were insufficient funds to pay the tax. *Manual Transmittal 5700-8, December 5, 1986*.
    - b. For a partnership bankruptcy, it appears that income tax liability passes to the partners in the usual manner.
  2. However, it appears that abandoned property may create income tax liability for the debtor.
    - a. After notice and a hearing, the trustee in bankruptcy may abandon property that is burdensome to the bankruptcy estate or is of inconsequential value and benefit to the estate. *11 U.S.C. § 554(a)*. But see *In re Schmid*, 54 *Bkrpcy. Rep.* 78 (D. Or. [*Bkrpcy.*] 1985) (inadvertent abandonment of lawsuit by trustee revoked where was mistake of trustee caused by ambiguous description of lawsuit by debtor in schedules). A trustee may abandon property of the estate without obtaining a court order authorizing abandonment when there is no objection to the proposed abandonment by an interested party. *In the Matter of Trim-x*, 695 *F.2d* 296 (7<sup>th</sup> Cir. 1982).
    - b. On the request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate. *11 U.S.C. § 554(b)*. *In re Gantt*, 98 *Bkrpcy. Rep.* 770 (S.D. Ohio [*Bkrpcy.*] 1989) (creditor can only seek motion for trustee to abandon; “notice of proposed abandonment” by secured creditor ineffective). Motions under this subsection are excepted from the category of adversary proceedings under Bankruptcy Rule 7001(1).
    - c. Scheduled property not administered before a case is closed is deemed abandoned to the debtor and is considered to have been administered. *11 U.S.C. § 554(c)*.
    - d. Unless the court orders otherwise, property of the estate that is not abandoned and that is not administered in the case remains property of the estate. *11 U.S.C. § 554(d)*.
    - e. A trustee or debtor in possession, unless the court directs otherwise, must give notice of a proposed abandonment or disposition of property to all creditors, indenture trustees and committees. *Bankruptcy Rule 6007(a)*.
      - (1) An objection may be filed and served by a party in interest within 15 days of the mailing of the notice or within the time fixed by the court. *Id.* If a timely objection is made, the court is to set

a hearing on notice. *Bankruptcy Rule 6007(c)*. Bankruptcy Rule 6007 does not apply to 11 U.S.C. § 554(c) under which property is deemed abandoned if not administered.

- (2) A debtor may have a due process interest in abandonments.
- f. Property subject to relief from the automatic stay is considered as abandoned for purposes of debtor liability for income tax on any gain involved. *Patrick Catalano, T.C. Memo. 2000-82* (residence involved; non recourse debt).
- g. Theories on income taxation in abandonment—
- (1) The movement of the debtor’s property into the bankruptcy estate upon filing does not trigger adverse tax consequences. *I.R.C. § 1398(f)(1)*. Similarly, the movement of the debtor’s property from the bankruptcy estate to the debtor does not trigger adverse tax consequences. *I.R.C. § 1398(f)(2)*.
- (a) Nothing is said about the tax consequences of abandonments so that type of transfer is apparently left to be handled under usual tax principles.
- (b) If an abandonment is properly characterized as involving a completed transfer to the bankruptcy estate followed by a transfer of the property back to the debtor, arguably the retransfer to the debtor would trigger tax liability in which case the tax liability would be trapped in the bankruptcy estate.
- (2) If, however, an abandonment is properly characterized as a “deflection” of property from the bankruptcy estate, the tax liability when the property is lost to creditors would rest with the debtor.
- (a) In support of this characterization, courts have held that the debtor is deemed to have continuously owned property abandoned in bankruptcy. *Brown v. O’Keefe, 300 U.S. 598 (1937)*; *Rosenblum v. Dingfelder, 111 F.2d 406, 409 (2d Cir. 1940)*; *In re Flamand, 78 Bkrpcy. Rep. 644, 645 (D. R.I. [Bkrpcy 1987])*. See *Mason v. Commissioner, 646 F.2d 1309 (9<sup>th</sup> Cir. 1980)* (involving continuation of S corporation election):

“When the court grants a trustee’s petition to abandon property in a bankrupt’s estate, any title that was vested in the trustee is extinguished, and the title reverts to the bankrupt, nunc pro tunc...The bankrupt is treated as having owned it continuously”.

See also *In re Cruseturner, 8 Bkrpcy. Rep. 581, 591 (D. Utah [Bkrpcy.] 1981)*:

“...when the trustee abandons property, the property stands as if no bankruptcy had been filed and the debtor enjoys the same claim to it and interest in it as he held previous to the filing of bankruptcy”.

However, both cases were based on facts arising before enactment of I.R.C. § 1398(f)(1) which provided specifically for the transfer of property “from the debtor to the estate.”

- (b) In *Matter of Bentley, 79 Bkrpcy. Rep. 413 (S.D. Iowa [Bkrpcy.] 1987)*, *rev’d 89-2 U.S.T.C. ¶ 9597 (S.D. Iowa 1988)*, *aff’d, 916 F.2d 431 (8<sup>th</sup> Cir. 1990)*, the trustee in bankruptcy in 1983 sold a corn crop free and clear of liens with the understanding that the CCC interest would attach to the proceeds and interest earned on the proceeds. In 1986, the trustee determined that the CCC claims were valid and exceeded the value of the crop. Accordingly, the trustee applied to abandon the proceeds. IRS argued that had the corn been abandoned prior to sale, the gain would not have accrued to the estate. However, once the trustee sold the grain, the estate became liable for the income tax on the proceeds. The bankruptcy court stated:

“The effect of the IRS position would have the estate pay taxes on property to which the estate is not entitled, did not retain and from which it received no benefit (because it was all abandoned) because the proceeds became property of the estate while subject to a lien which greatly exceeded its value. Such a result will not be countenanced.” 79 *Bkrpcy. Rep.* 416.

The bankruptcy court decision has been reversed by the United States District Court with the Eighth Circuit stating in affirming—

“...a contrary holding would have the effect of burdening the debtor’s fresh start under the bankruptcy law.”

See *In re Perlman*, 96-1 U.S.T.C. ¶ 50,116 (S.D. Fla. [Bkrpcy.] 1995) (unsuccessful attempt by trustee to abandon proceeds from sales of estate property).

- (c) Some courts have rejected the “entrapment” theory. *In re Olson*, 100 *Bkrpcy. Rep.* 468 (N.D. Iowa [Bkrpcy.] 1989), *aff’d*, 121 *Bkrpcy. Rep.* 346 (N.D. Iowa 1990), *aff’d*, 930 F.2d 6 (8<sup>th</sup> Cir. 1991) (abandonment of land to debtor; bankruptcy court acknowledged *McGowan* was “overbroad” in defining abandonment as “termination of estate” but nonetheless concluded that abandonments should be covered by I.R.C. § 1398(f)(2); Court of Appeals offered no theory for holding that the deflection theory applied); *In re Johnston*, 49 F.3d 538 (9<sup>th</sup> Cir. 1995) (court held requirements for abandonment did not include consideration of effect on debtor’s fresh start); *In re McGowan*, 95 *Bkrpcy. Rep.* 104 (N.D. Iowa [Bkrpcy.] 1988) (abandonment of bankruptcy estate property by trustee not “sale or exchange” triggering tax liabilities chargeable to estate; “termination of estate” language in I.R.C. § 1398(f)(2) stretched to cover abandonments); *In re Terjen*, 154 *Bkrpcy. Rep.* 456 (E.D. Va. [Bkrpcy.] 1993) (abandonment not taxable event to bankruptcy estate). See *Ltr. Rul.* 9245023, August 7, 1992 (abandonment of asset from bankruptcy estate to debtor was not sale or other disposition; debtor recognized gain on foreclosure; tax attributes of bankruptcy estate and basis of property in debtor’s hands reduced by discharge of indebtedness). See also *Ltr. Rul.* 9611028, December 14, 1995 (transfer of property of bankruptcy estate to debtor after plan confirmation but before estate termination is not taxable event by IRS view).
- (d) In the case of *In re Olson*, *supra*, the debtor prepared and filed state and federal fiduciary returns for the bankruptcy estate, duly reporting the gain. The trustee sued for damages, alleging malicious interference with the trustee’s duties. The court agreed the filing was not malicious and indicated a separate hearing would be set on the issue of damages and costs.
- (e) The IRS agrees with the holdings in *Bentley* and *McGowan* that abandonment of estate property by the trustee is not a transfer taxable to the estate and the debtor does not acquire a new basis. *Letter from James Keightly, Associate Chief Counsel to Michael Paup, Deputy Assistant Attorney General, March 14, 1989.* See *Ltr. Rul.* 9017075, January 31, 1990 (tax consequences of sale of partially exempt residence; ruling later revoked on issue of taxation of residence by *Ltr. Rul.* 9122042, March 4, 1991 (gain is liability of bankruptcy estate).
- (f) The U.S. District Court for Minnesota in 1989 reversed the bankruptcy court in *In re Laymon*, Civ. 6-89-235 (D. Minn. 1989) and held that the bankruptcy court had erroneously approved the trustee’s request for abandonment. At issue was approximately \$17,000 of income tax liability on farmland. The trustee had collected two years of rental on the land totaling about \$22,000 before seeking to abandon the property. The court noted that the trustee had a duty to the debtor as well as to the unsecured creditors and pointed out that the trustee has a “general duty not to burden unduly the debtor’s opportunities for a fresh start.” The court said that the impact of abandonment on debtors “is one aspect to consider on the issue of burdensomeness.”

(g) In the 1991 case of *In re A. J. Lane & Co.*, 92-1 U.S.T.C. ¶ 50,059 (D. Mass. [Bkrpcy.] 1991), the bankruptcy court denied abandonment of property to a debtor where the tax consequences were substantial; the court indicated that abandonment would be taxable to the bankruptcy estate and emphasized the importance of a “fresh start” for the debtor; *In re Rubin*, 154 Bkrpcy. Rep. 897 (D. Md. [Bkrpcy.] 1992) (abandonment was taxable disposition to bankruptcy estate). See *Matter of Nebel*, 175 Bkrpcy. Rep. 306 (D. Neb. [Bkrpcy.] 1994) (tax liability was responsibility of bankruptcy estate; ineffective abandonment). Compare *In re Nevin*, 135 Bkrpcy. Rep. 652 (D. Hawaii [Bkrpcy.] 1991) (abandonment involving partnership as debtor; court rejected argument that abandonment would hamper partner’s fresh start).

(h) For corporations and other entities that do not receive separate entity status, abandonment is a disposition taxable to the corporate or other taxpayer for federal income tax purposes.

(3) IRS has issued proposed regulations specifying that transfer of an interest in a passive activity (or a former passive activity) to the debtor, other than by sale or exchange, prior to the termination of the bankruptcy estate, is not to be treated as a taxable disposition. *Prop. Treas. Reg. § 1.1398-1(d)(1)*. The proposed regulations are generally effective for bankruptcy cases commencing after November 8, 1992 and are applicable to cases commencing earlier and terminating after that date if the debtor and estate jointly and irrevocably elect to apply the proposed regulation. See *Prop. Treas. Reg. § 1.1398-1(f)(2)(vi), -2(f)(2)(vi)*.

(4) Quite clearly, legislation or a ruling is needed to establish the tax consequences of abandonments. It would seem to be consistent with the Bankruptcy Tax Act for abandonments not to produce adverse tax consequences for the debtor. Legislation has been introduced to mandate the “entrapment” theory with gain on abandoned property taxed to the bankruptcy estate. *H.R. 4645, Sec. 3, 105<sup>th</sup> Cong., 2d Sess. (1998)*.

(5) Should a lifting of the automatic stay (with the resulting opportunity for creditors to exercise their rights with respect to the property) be treated differently from abandonment?

h. It is suggested that the debtor resist abandonments if significant potential income tax liability is involved.

(1) One strategy that has been used is to abandon property to the creditor. See *In re Butler*, 51 Bkrpcy. Rep. 261 (D. D.C. [Bkrpcy.] 1984). But see *Matter of Popp*, 166 Bkrpcy. Rep. 697 (D. Neb. [Bkrpcy.] 1993) (court denied abandonment to creditor requested by debtor because of debtor’s potential income tax liability on farm machinery; bankruptcy court stated there would be no income tax consequences to debtor under I.R.C. § 1398(f)(2)).

(2) It is not clear whether abandonment to the creditor alters the income tax consequences.

3. The debtor may be liable under some circumstances for any gain or loss from the distribution of the property to creditors or from the sale of the property. See *In re Sonner*, 53 Bkrpcy. Rep. 859 (E.D. Va. [Bkrpcy.] 1985) (debtor liable for gain realized by creditors’ trust, held to be grantor’s trust, established under Chapter 11 plan to sell debtor’s property to pay creditors). Watch this point in particular with S corporations. The U.S. Supreme Court has held that a trustee appointed to liquidate and distribute property as part of a Chapter 11 bankruptcy plan is required to file a return and pay taxes on the income attributable to the property as an assignee of all or substantially all of the debtor’s property. *Holywell Corp. v. Smith*, 503 U.S. 47 (1992).

b. For conditions under which IRS will issue advance rulings on entities created as liquidating trusts in bankruptcy, see *Rev. Proc. 94-45, 1994-2 C.B. 684*.

#### G. Special income tax concerns in Chapter 12

1. Chapter 12 bankruptcy estates are not eligible for separate entity status under the Bankruptcy Tax Act of 1980 for federal income tax purposes. See *I.R.C. § 1398(a)* (applicable to Chapter 7 and 11 filers). *Ltr. Rul. 8928012, April 7, 1989*. Indeed, the 1980 legislation denies separate entity status to other bankruptcy filers. *I.R.C. § 1399*.
  - a. Therefore, income tax liability incurred in a Chapter 12 bankruptcy is the responsibility of the debtor. *In re Lindsey, 92-2 U.S.T.C. ¶ 50,400 (W.D. Okla. [Bkrpcy.] 1992)* (trustee acted in capacity as standing trustee, not as trustee of separate liquidating trust).
  - b. This seemingly overrides earlier law recognizing separate entity status in other settings. E.g., *Ralph Roger Bergman, T.C. Memo. 1985-256* (individual's bankruptcy estate was separate taxable entity); *Rev. Rul. 78-134, 1978-1 C.B. 197* (separate entity for individual bankrupt); *Rev. Rul. 72-387, 1972-2 C.B. 632* (same).
  - c. The estate of a corporation in bankruptcy clearly is not a separate entity for federal income tax purposes. *Treas. Reg. § 1.641(b)-2(b)*.
  - d. Before the Bankruptcy Tax Act of 1980 became effective, the estate of a bankrupt partnership was considered to be a separate taxable entity. *Rev. Rul. 68-48, 1968-1 C.B. 301* (separate entity created for bankrupt partnership treated as estate).
  - e. Before enactment of the Bankruptcy Tax Act, even with separate entity status, the transfer of the bankrupt's assets to the trustee in bankruptcy was not a taxable event and the basis carried over to the trustee. *Rev. Rul. 78-134, 1978-1 C.B. 197*.
  - f. A Chapter 12 debtor may not be liable for post-petition interest on pre-petition tax liabilities paid through a confirmed plan. *IRS v. Cousins, No. 99-121-JD (D. N.H. 1999)*.
2. Investment tax credit has been required to be recaptured on transfer of assets to the trustee in bankruptcy unless it was a mere change in form. See *Henry C. Mueller, 60 T.C. 36 (1973), aff'd and rev'd on other issues, 496 F.2d 899 (5th Cir. 1974)* (voluntary petition in bankruptcy to liquidate); *Rev. Rul. 74-26, 1974-1 C.B. 7, obsoleted by Rev. Rul. 90-25, 1990-1 C.B. 10* (transfer to trustee to liquidate business).
3. Deductibility of administrative expense—
  - a. For individuals filing under Chapters 7 or 11, administrative expenses are deductible. *I.R.C. § 1398(h)(1)*. However, there is no deduction for administrative expenses for which there is no legal obligation to pay. *Claude T. Allen, T.C. Memo. 1990-651* (legal expenses written off by law firm because of conflict of interest).
  - b. There was authority, before enactment of the Bankruptcy Tax Act, that the expenses of the bankruptcy estate were deductible under *I.R.C. § 212*. *Rev. Rul. 68-48, 1968-1 C.B. 301, 302* (“usual costs of administration, including the referee's compensation, statutory compensation for the trustee and for the bankrupt's attorney, the trustee's bond premium...”). See *Ralph Roger Bergman, T.C. Memo. 1985-256* (deductions for real estate taxes, interest and legal fees available to bankruptcy estate, not debtor); *Herbert E. Cox, T.C. Memo. 1981-552* (bankrupts allowed to deduct portion of attorney's fee representing portion of debts that were business debts); *Maurice Artstein, T.C. Memo. 1970-220* (portion of attorney's fee for filing bankruptcy petition not deductible in voluntary petition to liquidate in bankruptcy because not sufficiently related to trade or business and not deductible as expense in connection with transaction entered into for profit).
  - c. For assets subject to a relief from the stay, property is considered outside the bankruptcy estate with deductibility of costs if the assets were related to a business or would otherwise meet the tests of deductibility. *Patrick Catalano, T.C. Memo. 2000-82* (residence subject to relief from stay; nonrecourse debt involved).

4. Quite clearly, legislation is needed to make those filing Chapter 12 bankruptcy eligible for separate entity status for federal income tax purposes.

#### H. Post-bankruptcy relationships.

1. A transfer of an asset from the bankruptcy estate to the debtor in the event of termination of the bankruptcy estate is not treated as a disposition and the debtor is treated as the bankruptcy estate would be treated. *I.R.C. § 1398(f)(2)*. Confirmation of the plan vests all estate property in the debtor except as may be provided in the plan. *11 U.S.C. § 1141(b)*.
2. Mutual pre-petition claims and obligations are subject to set-off. *11 U.S.C. § 553*. In general, pre-petition debts cannot be offset against post-petition liabilities where mutuality is lacking. *In re Braniff Airways, Inc., 42 Bkrpcy. Rep. 443, 449 (N.D. Tex. [Bkrpcy.] 1984)*.
  - a. Mutuality is present only if the claims and debts are mutual, involving the same parties, in the same right or capacity, and of the same kind or quality. See *In re Whitman, 38 Bkrpcy. Rep. 395, 397 (D. N.D. [Bkrpcy.] 1984)*.
  - b. Mutuality is lacking where a post-petition liability is owed to a trustee or debtor in possession because they differ from the pre-petition debtor. *In re Braniff Airways, Inc., 42 Bkrpcy. Rep. 443, 449-450 (N.D. Tex. [Bkrpcy.] 1984)*.
  - c. If debtors incur a pre-petition tax liability to the United States, and the United States incurs a post-petition liability to the debtors, such as with a government farm program, a set-off is permissible. *In re Schons, 54 Bkrpcy. Rep. 665 (W.D. Wash. [Bkrpcy.] 1985)* (Milk Diversion Program payments from U. S. Department of Agriculture). See *In re B & P Enterprises, Inc., 67 Bkrpcy. Rep. 179 (W.D. Tenn. 1986)* (refund of personal income tax offset against corporate taxes and penalties for which taxpayers were responsible parties); *In re IML Freight, Inc., 65 Bkrpcy. Rep. 788 (D. Utah [Bkrpcy.] 1986)* (IRS allowed setoff of income tax penalties against shipping charges owed by United States to debtor).

## VII. Special income tax problems for sellers of assets

### A. Disposition of installment obligation—

1. The privilege of income deferral by installment reporting under *I.R.C. § 453* is generally personal to the party electing the installment method and does not outlast the period during which the obligation is held.
2. Sale, gift or other disposition or satisfaction of an installment obligation results in recognized gain to the taxpayer. *I.R.C. § 453B(a)*.
  - a. The amount of gain or loss is the difference between the basis of the installment obligation at the time of disposition and either the amount realized in a sale or the fair market value of the obligation at the time it is disposed of other than by sale. *I.R.C. § 453B(a)*. The rules for determining taxable gain on disposition of an installment obligation are different depending upon how the disposition occurs.
    - (1) If the installment obligation is satisfied at other than face value or it is sold or exchanged, the amount to be included in income is the difference between the amount realized and the income tax basis of the obligation. *I.R.C. § 453B(a)(1)*. With this type of disposition, consideration is received.
    - (2) If the disposition takes the form of a “distribution, transmission, or disposition otherwise than by sale or exchange,” the amount included in income is the difference between the fair market

value of the obligation and its income tax basis. *I.R.C. § 453B(a)(2)*. *Rev. Rul. 79-371, 1979-2 C.B. 294*.

- b. For a discussion of the consequences of pledging an installment obligation, see Part Five.
- c. Disposition of a contract to children in exchange for annuity payments constitutes a taxable disposition. *Harold W. Smith, 56 T.C. 263 (1971)*.
- d. In a disposition by gift, the donee's income tax basis presumably would be the fair market value of the obligation inasmuch as the donor's basis would be increased by virtue of the taxable disposition.
- e. A tax-free exchange to a corporation or partnership does not trigger taxability of installment obligations transferred. See *Treas. Reg. § 1.453-9(c)(2)*.
- f. Assignment of a note by a nominee to a beneficial owner does not trigger recognition of gain. *Irving Snyder, 66 T.C. 785 (1976), acq., 1976-2 C.B. 3*.
- g. Death of the seller—
  - (1) In the event of death of the seller within the term of an installment sale transaction, income tax on the deferred gain is not immediately due, but the installment obligation as an asset of the estate does not receive a new or adjusted basis. *I.R.C. §§ 691(a)(4), 453B(c)*. Payments received after death are treated as income in respect of decedent and the recipient, whether estate representative, legatee or other successor, reports the income in the same manner as the decedent would have done if living. *Treas. Reg. § 1.691(a)-5*. See *Trust Co. of Georgia v. Ross, 262 F. Supp. 900 (N.D. Ga. 1966), aff'd, 392 F.2d 694 (5th Cir. 1967), cert. denied, 393 U.S. 830 (1968)* (sale of stock in escrow); *Ray Bert Hedrick, 63 T.C. 395 (1974)*; *Claiborne v. United States, 648 F. 2d 448 (6th Cir. 1981)* (closing of land transaction after owner's death); *Ltr. Rul. 9023012, March 6, 1990* (land contract cancelable if mortgage commitment not obtained within 45 days and decedent died within 45-day period; mortgage commitment not obtained but parties proceeded to closing and gain was income in respect of decedent). See *Ltr. Rul. 8302044, October 8, 1982* (any difference in face amount of obligation and valuation for federal estate tax purposes has no effect on amount included in recipient's gross estate). Cf. *Rev. Rul. 76-100, 1976-1 C.B. 123* (community property). See *Sun First National Bank of Orlando v. United States, 607 F.2d 1347 (Ct. Cl. 1979)* (amounts received by grantor trust).
  - (a) The fair market value of the obligation is includible in the decedent's gross estate. However, a deduction is permitted each recipient of income in respect of decedent equal to the death taxes attributable to the value of the obligation. *I.R.C. § 691(c)*. See *Ltr. Rul. 9007016, November 16, 1989* (no recognition of gain to estate where installment obligation transferred outright to surviving spouse or in satisfaction of residuary bequests). The value of the installment obligation may not be reduced by the estimated amount of income tax payable on installments remaining to be paid. *Estate of Robinson, 69 T.C. 222 (1977)*.
  - (b) Except for distributions to the obligor, a decedent's estate is not charged with income inclusion as a result of distribution of the obligation to a beneficiary. *I.R.C. § 453B(c)*. The basis in the hands of a beneficiary is the decedent's basis, adjusted for installments received by the estate prior to distribution.
  - (c) However, disposition of installment obligations entered into by the estate constitutes a taxable disposition. See *Rev. Rul. 55-159, 1955-1 C.B. 391*. *I.R.C. § 1040* operates to shield from recognition the gain on transfer of special use value land to a qualified heir. *I.R.C. § 1040(a)*. However, *I.R.C. § 1040* does not appear to shield from recognition the

gain on distribution of an installment obligation from the estate. This problem is especially severe for sale by an estate of land under a special use valuation election. The exception in I.R.C. § 453B(c) would appear not to apply to installment obligations entered into by the estate inasmuch as the distributions of installment obligations from estates would not involve “transmission of installment obligations at death”. *I.R.C. § 453B(c)*. See *Rev. Rul. 55-159, 1955-1 C.B. 391* (distribution of installment obligation from trust to beneficiary was taxable disposition). See also *Ltr. Rul. 8317050, January 25, 1983* (same).

- (d) Disposition of an installment obligation at death to the obligor is treated as a taxable disposition. *I.R.C. § 691(a)(4),(5)*. See *Rev. Rul. 86-72, 1986-1 C.B. 253* (gain recognized and includible in decedent seller’s estate where installment note automatically cancelled upon seller’s death). Any previously realized gain from an installment sale is recognized by a deceased seller’s estate if the obligation is transferred by bequest, devise or inheritance to the obligor or is cancelled by the executor or administrator of the estate.
- [1] The disposition is considered to occur at the earliest of the executor’s assent to distribution of the installment obligation to the buyer, the cancellation of the obligation by the executor, the time the obligation becomes unenforceable or the termination of the administration of the estate for federal estate tax purposes. *Ltr. Rul. 8552007, September 18, 1985*.
- [2] If the cancellation occurs at the death of the holder of the obligation, the cancellation is treated as a transfer by the estate of the decedent. However, if the obligation were held by a person other than the decedent such as a trust, the cancellation is treated as a transfer by that person immediately after the decedent’s death. *I.R.C. § 691(a)(5)(A)*.
- [3] If the decedent and the obligor are related persons, the fair market value of the obligation for disposition purposes is not less than the face amount. *I.R.C. § 691(a)(5)(B)*.
- (2) The feature of installment obligation taxation that converts gain in such obligations into income in respect of decedent constitutes an income tax disadvantage (for property that has appreciated substantially in value) compared with retention of the property until death and concomitant eligibility for a new basis. *I.R.C. § 1014(a)*.
- h. Cancellation of an installment obligation is treated as a disposition of the obligation by the holder. *I.R.C. § 453B(f)*.
- (1) Thus, if the seller forgives or cancels the obligation to pay amounts due, the result is the same as a disposition of the obligation. If the obligor is a related party, the amount taken into account as a disposition triggering recognition of unreported gain attributable to the obligation is not less than the face amount of the installment obligation. *I.R.C. § 453B(f)(2)*.
- (2) IRS has ruled that cancellation of principal in a debt restructuring involving an installment sales contract does not result in income tax consequences to the seller. *Ltr. Rul. 8739045, June 30, 1987* (no recognition of the enactment of *I.R.C. § 453B(f)*).
- i. All depreciation recapture on installment sales of real or personal property is taxed to the seller in the year of sale. This is the outcome even if no principal payments are received. This is a change applicable to installment sales entered into after June 6, 1984, except for contracts binding on March 22, 1984.
- (1) For other installment sales, the income (other than interest) on each payment is first deemed to be recapture income under *I.R.C. § 1245* or *I.R.C. § 1250*. *Treas. Reg. § 1.1245-6(d)(1)*; *Treas.*

*Reg. § 1.1250-1(c)(6). Dunn Construction Co. v. United States, 323 F. Supp. 440 (N.D. Ala. (1971); Antone E. Plese, T.C. Memo. 1978-326. If the statute of limitations has run on the recapture year, the recapture amount cannot be assessed in a later, open, year. Ltr. Rul. 8326002, February 28, 1983.*

- (2) For expense method depreciation assets disposed of by installment sale, all payments received under the obligation are considered to have been received in the year of sale to the extent of expense method depreciation claimed on the property. *I.R.C. § 453(i).*
  - j. Exchange of the property securing the installment obligation for another property without otherwise changing the terms of the obligation is not a disposition. *Ltr. Rul. 8848054, September 7, 1988* (substitution of new property as security for installment obligation secured by property sold under threat of condemnation not disposition of installment obligation).
- B. Modification of contract terms**
1. A modification resulting in a deferral of the principal due and an increase in the interest rate does not result in a taxable disposition. *Rev. Rul. 68-419, 1968-2 C.B. 196. See Ltr. Rul. 8119030, February 11, 1981; Ltr. Rul. 8437091, June 14, 1984; Ltr. Rul. 9505011, November 4, 1994* (postponement of maturity dates of note and deferral of principal payments for valid business reasons not disposition or satisfaction). See also *Ltr. Rul. 8545010, August 12, 1985* (not a disposition where substitution in property securing debt, flat interest rate substituted for variable rate and term of obligation shortened from 16 to 10 years); *Ltr. Rul. 9819043, February 11, 1998* (modifications of terms of notes not significant; rights of obligees not materially altered).
    - a. Similarly, an agreement reducing payments, allocating all payments to interest and deferring principal payments (and some interest) for two years is not a disposition. *Ltr. Rul. 8606052, November 15, 1985* (warning about using test rate of interest when payments resume). See *Rhombar Co., 47 T.C. 75 (1966), acq., 1967-1 C.B. 2* (no constructive receipt on deferral of scheduled payments); *Ltr. Rul. 9506018, November 7, 1994* (postponing principal payments was not disposition of note).
    - b. The substitution of a mortgage contract, in an amount equal to the unpaid balance of the purchase price, payable on the same terms and conditions of payment as the balance under the installment obligation, results only in a change in the type of security and does not constitute a satisfaction or disposition of the installment obligation. *Rev. Rul. 55-5, 1955-1 C.B. 331. See Rev. Rul. 82-122, 1982-1 C.B. 80* (substitution of new obligor and change in rate of interest not considered disposition); *Rev. Rul. 75-457, 1975-2 C.B. 196* (substitution of obligors, deeds of trust and promissory notes not disposition where no change in terms or conditions of original deeds and notes); *Rev. Rul. 74-157, 1974-1 C.B. 115* (substitution of two promissory notes and two deeds of trust for existing promissory note and deed of trust was not disposition). See also *Ltr. Rul. 9238005, June 8, 1982* (mere change in collateral securing sale did not affect installment reporting).
  2. If the buyer sells the property and the seller agrees to a “novation” there apparently is no disposition. See *John I. Cunningham, 44 T.C. 103 (1965).*
  3. No disposition occurs on release of a blanket mortgage to facilitate sale of individual land parcels. *Ltr. Rul. 7852124, October 2, 1978.*
  4. If there is a substantial change in the terms of the obligation, the current rules on minimum interest rates apply. See *Treas. Reg. § 1.483-1(c)(4).*

## **VIII. Repossession of property**

### **A. Repossession of land under installment sale**

1. The statutory provisions under I.R.C. § 1038 governing the calculation and reporting of gain on repossession of real property are mandatory if the transaction comes within the statute. *Treas. Reg. § 1.1038-1(a)(1)*.
  - a. In applying I.R.C. § 1038, it is immaterial whether the seller realized a gain or sustained a loss on the sale of the real property or whether it can be ascertained at the time of sale whether a gain or loss occurred. *Treas. Reg. § 1.1038-1(a)(1)*.
  - b. It is also immaterial what method of accounting the seller used in reporting gain or loss from the sale or whether at the time of reacquisition the property has increased or decreased in value since the time of the original sale. *Treas. Reg. § 1.1038-1(a)(1)*.
  - c. The provisions of I.R.C. § 1038 do not apply if the disposition constitutes an exchange of the property. *Treas. Reg. § 1.1038-1(a)(2)*.
  - d. The provisions of I.R.C. § 1038 do not apply except where indebtedness was secured by real property. *Treas. Reg. § 1.1038-1(a)(1)*.
    - (1) Therefore, reconveyance of property by the obligor under a private annuity to the annuitant would appear not to come within I.R.C. § 1038.
    - (2) Reacquisition of oil and gas leases is eligible for repossession treatment under I.R.C. § 1038. *Ltr. Rul. 9833005, May 12, 1998*.
  
2. Calculating gain on repossession of property—
  - a. On repossession, the amount of gain recognized is the lesser of— (1) the amount of cash and the fair market value of other property received prior to the reacquisition (but only to the extent such money and other property exceeds the amount of gain reported prior to the reacquisition), or (2) the amount of gain realized on the original sale (adjusted sales price less adjusted income tax basis) in excess of the gain previously recognized before the reacquisition and the money or other property transferred by the seller in connection with the reacquisition. *I.R.C. § 1038(b)(2)*. See *Ltr. Rul. 8736026, June 5, 1987* (Section 1038 applies to repossession of farm land by seller through forfeiture of installment sales contract after several modifications of payment terms). See *Ray R. Conners, 88 T.C. 541 (1987)* (gain on repossession of improved real property limited to amount of downpayment received and amount of seller's indebtedness discharged by buyer and did not include increase in fair market value from improvements made by buyer). Compare *Sooren Houhannissian, T.C. Memo. 1997-444* (portion of cash received on installment sale not previously reported as gain taxable; although property was substantially changed by modifications, it was not divisible so argument that I.R.C. § 1038 applied only to one portion rejected). Section 1038 applies to voluntary cancellations of installment obligations, even to those involving related parties. *Ltr. Rul. 8402006, September 22, 1983*. Amounts of interest received, stated or unstated, are excluded from the computation of gain. *Treas. Reg. § 1.1038-1(b)(2)(iii)*.
    - (1) Because I.R.C. § 1038 is applicable only when the seller reacquires the property to satisfy the purchaser's debt, it is generally inapplicable where the seller repurchases the property by paying the buyer an extra sum in addition to cancellation of the debt. See *Stephen B. Scallen, T.C. Memo. 1987-412* (Section 1038 did not apply where property sold by one of taxpayer's controlled corporations to third party was reacquired by another controlled corporation which paid additional consideration but sales contract did not provide for payment of additional consideration on reacquisition).
    - (2) I.R.C. § 1038 generally is applicable, however, if the seller reacquires the property when the purchaser has defaulted or when default is imminent even if the seller pays additional amounts. *Treas. Reg. § 1.1038-1(a)(3)(i)*.

**Example**

Farmland acquired in 1950 was sold by X under installment contract on January 2, 1983, to Y for \$150,000 calling for \$15,000 down and payments of \$15,000 per year for nine years. The property had an adjusted income tax basis at the time of sale of \$30,000. The seller received the down payment and the first regular payment for the following year, with all payments reported whereupon X proceeded to forfeit Y's interest in the property. The four-step computational procedure produces the following results—

**Step 1:** Calculate the amount of cash and the fair market value of the property received prior to reacquisition

Year of sale	\$15,000
Following year	<u>15,000</u>
	\$30,000

**Step 2:** Subtract the gain returned as income for the period prior to acquisition—

Determine gross profit	
	= \$150,000 - \$30,000
	= \$120,000
Determine total contract price	
	= \$150,000
Fraction reported as gain	
	= Gross profit / Total contract price
	= \$120,000 / \$150,000
	= 80%
Gain reported	
	= \$30,000 x 80%
	= \$24,000
Gain before application of second limitation	
Money and other property received	\$30,000
Less: gain reported	<u>24,000</u>
	\$6,000

**Step 3:** Determine the second limitation on amount of gain—

Sales price of property		\$150,000
Less: adjusted basis at time of sale	\$30,000	
plus gain returned as income before acquisition	<u>24,000</u>	
	\$54,000	<u>54,000</u>
Limitation on amount of gain		\$ 96,000

**Step 4:** Determine the lesser figure from Step 2 or Step 3 as the amount of gain resulting from acquisition. \$6,000

- b. The character of the gain from reacquisition is determined by the character of the gain from the original sale.
- (1) For an original sale reported on the installment method, the character of the reacquisition gain is determined as though there had been a disposition of the installment obligation. See *Treas. Reg. §§ 1.1038-1(d), 1.453-9(a)*. In the above example, the \$6,000 of gain would be treated as capital gain.
  - (2) If the sale was reported on the deferred payment method, and there was voluntary repossession of the property, the seller reports the gain as ordinary income.

- (3) If the debts satisfied were securities issued by a corporation, government or political subdivision, the gain would be capital gain.
  - c. The adjusted income tax basis for the property is the sum of three amounts– (1) the adjusted income tax basis to the seller of the indebtedness, determined as of the date of repossession; (2) the taxable gain resulting from reacquisition; and (3) the money and other property (at fair market value) paid by the seller as reacquisition costs. See *Treas. Reg. §§ 1.1038-1(g), 1.1038-1(h)*.
  - d. The holding period of the reacquired property, for purposes of subsequent disposition, includes the period during which the seller held the property prior to the original sale plus the period after reacquisition. *Treas. Reg. § 1.1038-1(g)(3)*. However, the holding period does not include the time between the original sale and the date of reacquisition.
3. The provisions on reacquisition of property generally apply to residences or the residence part of the transaction.
    - a. However, the repossession rules do not apply if– (1) an election is in effect for an over age 55 sale or sale and reinvestment and (2) the property is resold within one year after the date of reacquisition. *I.R.C. § 1038(e)*.
      - (1) The resale is essentially disregarded and the resale is considered to constitute a sale of the property as of the original sale. The subsequent resale is treated as part of the original sale of the property. In general, the resale is treated as having occurred on the date of the original sale. An adjustment is made to the sales price of the old residence and the basis of the new residence.
      - (2) If not resold within one year, gain is recognized under I.R.C. § 1038. See *I.R.C. § 1038(e)*.
      - (3) An I.R.C. § 121 election is considered to be in effect if an election has been made and not revoked as of the last day for making such an election. *Treas. Reg. § 1.1038-2(a)(1)*. The I.R.C. § 121 exclusion can, therefore, be made after reacquisition. An election to exclude gain under I.R.C. § 121 can be made at any time within three years after the due date of the return. *I.R.C. § 121(c)*.
    - b. No bad debt deduction is permitted for a worthless or partially worthless debt secured by a reacquired personal residence and the income tax basis of any debt not discharged by the repossession is zero. Losses are not deductible on sale or repossession of a personal residence.
    - c. When gain is not deferred or excluded, the repossession of a personal residence is treated under the general rule of I.R.C. Section 1038 as a repossession of real property. Adjustment is made to the income tax basis of the reacquired residence.
  4. In 1969, the Internal Revenue Service ruled that the special provisions on income tax treatment of reacquisition of property did not apply to reacquisition by the estate of a deceased taxpayer. *Rev. Rul. 69-83, 1969-1 C.B. 202*.
    - a. A decedent's estate was not permitted to succeed to the income tax treatment that would have been accorded a reacquisition by the decedent.
    - b. The Installment Sales Revision Act of 1980 changed that result. *I.R.C. § 1038(g)*. The provision is effective for "acquisitions of real property by the taxpayer" after October 19, 1980.
      - (1) Presumably, that means acquisitions by the estate or beneficiary. Under the 1980 amendments, the estate or beneficiary of a deceased seller is entitled to the same nonrecognition treatment upon the acquisition of real property in partial or full satisfaction of secured purchase money debt as the deceased seller would have been.

- (2) The income tax basis of the property acquired is the same as if the original seller had reacquired the property except that the basis is increased by the amount of the deduction for federal estate tax which would have been allowable had the repossession been taxable.
5. The Internal Revenue Service ruled in 1986 that the nonrecognition provisions of I.R.C. § 1038 do not apply to a former shareholder of a corporation who receives an installment obligation from the corporation in a Section 337 liquidation when that shareholder, upon default by the buyer, subsequently receives the real property used to secure the obligation. *Rev. Rul. 86-120, 1986-2 C.B. 145* (acquisition of the property by the shareholder did not restore the property to the original seller).
6. Litigation expenses incurred in a foreclosure action to reacquire title may not be deductible. See *James J. Freeland, T.C. Memo. 1986-10* (origin of litigation is controlling factor and no deduction allowed if origin of claim involves acquisition of capital asset).
- B. Repossession of personal property**
1. If a seller repossesses personal property, originally sold under the installment method, the seller realizes gain or loss the same as though the note or other obligation had been sold.
  2. Gain or loss is recognized in the year of repossession.
  3. If the repossession is voluntary—
    - a. A voluntary repossession occurs when the purchaser, unable to make payments, voluntarily agrees to return the property to the seller in full satisfaction of the outstanding debt.
    - b. In a voluntary repossession, the gain or loss is determined by the difference between—
      - (1) The fair market value of the repossessed personal property (determined as of the date of repossession) and
      - (2) The seller's income tax basis in the purchaser's note or other obligation that is satisfied by the repossession. The seller's basis in the obligation is the face value of the purchaser's note (contract price less the principal payments made under the contract) minus the unrealized profit (the percentage of profit times the unpaid principal balance). The seller must adjust this basis figure for any other amounts collected or costs incurred in repossession.

**Example 1**

A farmer sold a tractor for \$30,000 under installment contract. The seller's income tax basis was \$18,000. The gain of \$12,000 was reported with a 40 percent gross profit percentage. The buyer defaulted when the outstanding balance was \$20,000 and the fair market value of the property was \$16,000. The seller offered to cancel the outstanding obligation if the purchaser would return the tractor. The purchaser agreed to return the tractor in full satisfaction of the obligation. The seller paid \$1200 in legal fees on repossession.

FMV of property when repossessed		\$16,000
Less seller's basis in obligation given up—		
Original contract price	\$30,000	
Less payments received	(10,000)	
Balance	\$20,000	
Less deficiency judgment	0	
Balance	\$20,000	
Less unrealized profit (20,000 X .40)	(8,000)	
	12,000	(12,000)

Less repossession costs	<u>(1,200)</u>
Recognizable gain	\$2,800

- c. The character of the gain or loss is the same as on the original sale.
- (1) If the obligation arose from a sale by a dealer to a customer, gain or loss on repossession is ordinary income. The amount can be shown (on the dealer's income tax return and in the dealer's books) as an adjustment to cost of goods sold. For a gain, purchase cost would be decreased; for a loss, purchase costs would be increased.
  - (2) If the original sale was Section 1231 property, it would be shown on Form 4797 with a separate sheet showing the computation of gain or loss.
  - (3) If the original sale involved a capital asset and it was nonbusiness property, it would be shown on Schedule D with a separate sheet showing the computation of the gain or loss.
4. If repossession is involuntary —
- a. An involuntary repossession or foreclosure occurs when the purchaser is in default and is unwilling to return the property to the seller. The foreclosure sale or other action by the seller may involve bidding by the original seller or by a third party to reacquire the property. The original seller may buy back the property or a third party may purchase the property and turn over the proceeds to the seller.
    - (1) If the original seller regains the property, it is assumed the seller paid the current fair market value for the property.
    - (2) In either case, the fair market value of the property at the time of sale may not be sufficient to cover the outstanding debt. In that event, the seller may obtain a deficiency judgment against the original purchaser for the remaining debt. The seller in that event receives only a partial payment of the debt; the original purchaser remains liable for the balance as evidenced in the deficiency judgment.
  - b. The gain or loss is computed using the same procedure as in a voluntary repossession.

### Example 2

Assume the same facts as in Example (1) above (sale of tractor for \$30,000, seller's income tax basis of \$18,000, gain of \$12,000 had been reported with a 40 percent gross profit percentage) except that the property was not returned voluntarily. The seller took action under UCC default rules with the property sold. A third party purchased the property for \$16,000 which was the fair market value of the property at that time. The \$16,000 of proceeds were applied in partial satisfaction of the \$20,000 outstanding at that time on the obligation. A deficiency judgment for \$4,000 in favor of the seller was obtained for the remaining amount of the obligation. The gain on the repossession would be calculated as follows—

Fair market value on repossession		\$16,000
Less seller's basis in obligation given up—		
Original contract price	\$30,000	
Less payments received	<u>(10,000)</u>	
Balance	20,000	
Less deficiency judgment	<u>(4,000)</u>	
Balance	16,000	
Less unrealized profit		
(16,000 X .40)	<u>(6,400)</u>	
	9,600	(9,600)

Less repossession costs	<u>(1,200)</u>
Recognizable gain	\$5,200

**Explanation:** The seller received \$16,000 (the cash received). The income tax basis in the amount received is \$9,600 (60 percent of the \$16,000 face value). The gain of \$6,400 is adjusted downward by the costs of repossession which were \$1,200. The result is \$5,200 of recognized gain.

**Comparison:** Involuntary repossession in Example (2) produced a recognized gain of \$5,200 whereas the voluntary repossession of Example (1) resulted in a recognized gain of only \$2,800. The difference is attributable to the fact that in Example (1), the seller cancelled the entire outstanding debt of \$20,000, but only \$16,000 of outstanding debt was cancelled in Example (2). The buyer remained liable for the \$4,000 balance of the outstanding obligation because of the deficiency judgment. If and when the entire deficiency judgment amount of \$4,000 is paid, the seller must report \$1,600 of gain. Of the \$4,000 received, 60 percent or \$2,400 would be return of basis.

- c. The income tax basis of the reacquired property in the hands of the seller for purposes of a subsequent disposition (or for depreciation) would be the fair market value of the property at the time of the involuntary repossession. The income tax basis is the same whether repossession is voluntary or involuntary.
- d. Allowance of bad debt deduction—
  - (1) When an involuntary repossession occurs, a bad debt deduction is allowable if the outstanding debt is greater than the fair market value of the item repossessed by the seller. See *I.R.C. § 166*.
    - (a) The timing and nature of the bad debt deduction depend upon whether the excess debt over the fair market value of the item received is uncollectible and whether the seller is a dealer in personal property.
    - (b) If the seller is not a dealer in personal property, a bad debt deduction is allowed in the year the remaining debt becomes completely worthless.
    - (c) A bad debt deduction is allowed a dealer only if the property is not repossessed.

### Example 3

Returning to the facts of Example (2), where the seller obtained a deficiency judgment for the remaining indebtedness of \$4,000, if the entire \$4,000 is determined to be uncollectible, the \$2,400 of seller's basis in the obligation (60 percent times \$4,000) would be allowable as a bad debt deduction if there is no recovery on the deficiency amount.

**Explanation:** The bad debt deduction in Example (3) equals the difference between the gain reported in Example (1) of \$2,800 and the gain reported in Example (2) of \$5,200. Thus, the final income tax consequences should be the same for a voluntary repossession and an involuntary repossession if no further amount is collected under the deficiency judgment.

## C. Repossession of personal property under a deferred payment sale

1. In the event that gain on a sale under a deferred payment agreement did not qualify for reporting under the installment method, or if the seller did not use installment reporting, the gain must be fully recognized in the year of sale. Thus, the receipt of principal after the year of sale is tax free.
2. The recognized gain or loss (where gain has been previously reported) is computed under the same rules as for repossessions following an installment sale.

- a. The gain or loss is measured by the difference between the fair market value of the property at the time of repossession and the seller's income tax basis in the obligation satisfied by receipt of the property.
- b. The seller's basis under deferred payment sales is higher, however, with deferred payment sales because the buyer's obligations or evidences of indebtedness are included at fair market value in determining the amount realized at the time of sale.

**Example 4**

Personal property was sold on June 1, 1982 for \$50,000, with a \$10,000 cash down payment and a note from the purchaser in the face amount of \$40,000 with interest at eight percent. The \$40,000 note in 1982 had a discounted fair market value of \$38,000. The seller's income tax basis in the property was \$30,000 at the time of sale. The purchaser's obligation called for 10 annual payments of \$4,000 each beginning July 1, 1983. On August 15, 1985, the seller repossessed the property because of failure by the purchaser to make the payment due July 1, 1985. At the date of repossession, the property had a fair market value of \$36,000.

**Gain on sale in 1982:**

Cash received	\$10,000
Fair market value of other property received	<u>38,000</u>
Amount realized	\$48,000
Adjusted basis	<u>30,000</u>
Gain recognized	\$18,000

**Gain on repossession in 1985:**

Fair market value of property (date of repossession)	\$36,000
Seller's basis in note (\$38,000 less \$8,000 for payments in 1983 & 1984)	\$30,000
Gain recognized in 1985 on repossession	\$6,000

**Comparison with installment sale:**

	<i>Gain</i>	<i>Deferred</i>	<i>Installment</i>
	<i>Reported</i>	<i>In Payment</i>	<i>Method</i>
		<i>Method</i>	
1982		\$18,000	\$4,000
1983			1,600
1984			1,600
1985			
(gain on repossession)			<u>6,000</u>
Total gain reported			\$24,000
			<u>16,800</u>
			\$24,000

Thus, the total gain reported would be the same regardless of which method of reporting was used.

3. The income tax basis of repossessed property which had been sold originally under deferred payment reporting) is the fair market value of the property reacquired.
4. Unpaid obligations outstanding at the time of repossession that are not fully satisfied by the fair market value of the property received give rise to a bad debt deduction. A bad debt may be either a business bad debt (giving rise to an ordinary loss) or a nonbusiness bad debt (giving rise to a short-term capital loss).
5. The character of the gain or loss on repossession of property sold originally under a deferred payment sale is determined by the character of the note or obligation, not by the character of the property at the time of the original sale.
  - a. If the obligation is cancelled by voluntary repossession, any gain is ordinary income except for securities issued by a corporation, government or political subdivision. Gain or loss from those

securities is treated as capital gain or loss.

- b. For an involuntary repossession, the character of the gain is determined from the nature of the obligation in the hands of the seller. If the obligation is a capital asset, any gain is a capital gain.

## IX. Bad debt deduction

### A. Elements needed for deductibility

1. An income tax deduction is allowed for debts which become worthless within the taxable year. *I.R.C. § 166(a)*. See *Allan V. Rose, T.C. Memo. 1987-19, aff'd, 855 F.2d 65 (2d Cir. 1988)* (no bad debt deduction allowed where mortgagor reacquired property through foreclosure).
2. For a bad debt to be deductible, there must be a debtor-creditor relationship involving a legal obligation to pay a fixed sum of money. *Treas. Reg. § 1.166-1(c)*. See *C. Wayne Litchfield, T.C. Memo. 1994-585* (purchase of stock from client to expedite payment of law firm's legal fees did not produce debtor-creditor relationship; long term capital loss could be claimed when stock became worthless).
  - a. A bad debt deduction may be claimed only if there is an actual loss of money or the taxpayer has reported the amount as income. No bad debt deduction can be claimed for income items not yet included in income. *Douglas v. Commissioner, 181 F.3d 87 (4th Cir. 1999)* (amount not included in income); *Frank A. Walter, T.C. Memo. 1996-200* (no nonbusiness bad debt deduction for punitive damages awarded but not received during tax year); *Martin H. Tonn, T.C. Memo. 2001-123* (no bad debt deduction for amounts represented by taxpayer's labor unless reported into income).
  - b. To be bona fide debt, there must be a reasonable belief of repayment. *Arthur Mayhew, T.C. Memo. 1994-310* (loan by accountant to individual to finance businesses, personal expenses and repay outstanding loans; not deductible as bad debt since no reasonable belief that repayment would occur). See *Glen H. Flood, T.C. Memo. 2001-39* (no bad debt deduction; failed to establish existence of bona fide debt).
3. To be deductible, the debt must be proved to be worthless with reasonable steps taken to collect the debt. See *Melvin J. Cole, T.C. Memo. 1987-228* (bad debt deduction not allowed where creditor failed to demonstrate that debtor had insufficient equity in assets to pay debt); *William R. Hill, T.C. Memo. 1987-424* (bad debt deduction not allowed where general partner failed to prove worthlessness of advances made to partnership or that partnership insolvent and made no demand for payment).
  - a. Bankruptcy is generally good evidence that at least part of a debt is worthless. *Treas. Reg. § 1.166-2(c)*. See *Treas. Reg. § 1.166-2(c)(2)*:
 

"In bankruptcy cases a debt may become worthless before settlement in some instances; and in others, only when a settlement in bankruptcy has been reached. In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under Section 166 to such later year".
  - b. It is not necessary to resort to action in court if it can be shown that a judgment would not be collectible. *Treas. Reg. § 1.166-2(b)*.
4. A deduction may only be claimed in the year a debt becomes worthless. *Leon H. Perlin Co., Inc., T.C. Memo. 1993-79* (failed to show advances became worthless in tax year in question); *Dennis R. Schenk, T.C. Memo. 1996-113* (lack of proof that debt became worthless in year claimed). A debt becomes worthless when there is no longer any chance it will be paid. It is not necessary to wait until a debt is due to determine its worthlessness.
5. Any recovery of a bad debt or part of a bad debt allowed as a deduction in a prior year is includible in

gross income in the year of recovery except to the extent excluded under I.R.C. § 111. See *Treas. Reg. § 1.166-1(f)*.

6. A debt may be totally or partially worthless. *Treas. Reg. § 1.166-3*. A debt is a totally worthless bad debt if the taxpayer is unable to collect what is still owed even though some of the debt had been collected in the past. *Treas. Reg. § 1.166-3(b)*. The amount remaining to be paid is eligible for a bad debt deduction.

## B. Business bad debts

1. Business bad debts are deducted directly from gross income.
  - a. A business bad debt relates to operating a trade or business and is mainly the result of credit sales to customers or loans to suppliers, clients, employers or distributors. *Mann Construction Co., T.C. Memo. 1999-183* (bad debt deduction allowed for loans to shareholder's son; loans made to keep son on as construction superintendent in times of low construction activity). See *In re Farrington, 111 Bkrpcy. Rep. 342 (N.D. Okla. [Bkrpcy.] 1990) aff'd, 91-1 U.S.T.C. ¶ 50,115 (N.D. Okla. 1991)* (debtor in bankruptcy entitled to business bad debt deduction for advances to corporation of which taxpayer was 49 percent shareholder and Section 1244 loss treatment had no effect on bad debt deduction; debtor's activities more extensive than those of most shareholders); *Litwin v. United States, 91-1 U.S.T.C. ¶ 50,229 (D. Kan. 1991), aff'd, 983 F.2d 997 (10<sup>th</sup> Cir. 1993)* (president's dominant motive for making loans, guarantees and advances to corporation was to protect existing business and further business interest in remaining employed); *Price v. Commissioner, 98-1 U.S.T.C. ¶ 50,432 (7<sup>th</sup> Cir. 1998)* (advances to corporation were capital contributions, not bona fide loans; bad debt deduction denied); *Plante v. Commissioner, 168 F.3d 1279 (11<sup>th</sup> Cir. 1999)* (business bad debt deduction denied for advances to closely-held corporation); *Nathan Boatner, T.C. Memo. 1997-379, aff'd, 164 F.3d 629 (9<sup>th</sup> Cir. 1998)* (no business bad debt deduction for advances to wholly-owned S corporation; repayment of advances depended upon success of corporation); *Jensen v. Commissioner, 00-1 U.S.T.C. ¶ 50,311 (10<sup>th</sup> Cir. 2000)* (corporate shareholders denied bad debt deduction; contributions to capital); *Koenig v. Commissioner, 00-1 U.S.T.C. ¶ 50,503 (9<sup>th</sup> Cir. 2000)* (unpaid commissions did not qualify as bad debt); *Wuertz v. United States, 99-2 U.S.T.C. ¶ 50,795 (Fed. Cl. 1999)* (loans to business did not support business bad debt deduction; debts not connected to trade or business); *In re A.J. Healey, 98-2 U.S.T.C. ¶ 50,836 (N.D. Ga. [Bkrpcy.] 1998)* (same); *Estate of Blazzard, T.C. Memo. 1991-296* (no business bad debt deduction for trust fund portion of unpaid employment taxes of bankrupt closely held corporation in which taxpayer had interest); *Edgar H. Gleason, Jr., T.C. Memo. 1991-418* (debt was bona fide business debt arising from debtor-creditor relationship involving products sold to retail service station owner); *Robert H. Lagoy, T.C. Memo. 1992-213* (loans made to retain client in accounting business gave rise to business bad debt deduction); *Jerry C. Baldwin, T.C. Memo. 1993-433* (primary motive to secure salary, a motive proximately related to trade or business); *Robert A. Read, T.C. Memo. 1997-262* (general partner as guarantor of bank loan to partnership denied bad debt deduction for payment of loan; no proof right of subrogation became worthless during tax year at issue); *Melvyn L. Bell, T.C. Memo. 1998-136, aff'd, 200 F.3d 545 (8<sup>th</sup> Cir. 2000)* (business bad debt deduction denied for partially worthless advances to corporations); *In re Curry, 96-2 U.S.T.C. ¶ 50,529 (W.D. Va. [Bkrpcy.] 1996)* (advances to corporation were investment, not to protect employment); *J&W Fence Supply Co., 99-1 U.S.T.C. ¶ 50,396 (S.D. Ind. 1999)* (bad debt deduction denied to S corporation; contribution to capital); *Edwin A. Helwig, T.C. Memo. 1999-386* (advances to corporation were business bad debt but unable to show debts became partially worthless during year); *William J. Fleischaker, T.C. Memo. 1999-427* (loan guaranty payment not deductible as business bad debt); *Dan E. Martens, T.C. Memo. 2000-46, aff'd, 01-1 U.S.T.C. ¶ 50,416 (5<sup>th</sup> Cir. 2001)* (no business bad debt deduction for loans to mother's maternity shop); *O'Neal's Feeder Supply, Inc. v. United States, 00-1 U.S.T.C. ¶ 50,193 (W.D. La. 2000)* (evidence did not support jury finding that livestock feed corporation's debts were worthless except as to two accounts); *Rogers v. United States, 58 F. Supp. 2d 1235 (D. Kan. 2000)* (no bad debt deduction on loan to former shareholder of S corporation; essentially a redemption of stock); *Allen C. Chamberlin, T.C. Memo. 2000-50* (shareholder loan to corporation; loans in nature of investment in corporation—not deductible as

business bad debt); *Edward L. Provost, T.C. Memo. 2000-177* (business bad debt deduction denied; resembled investment in joint venture); *Philip A. Sellers, T.C. Memo. 2000-235* (investment banker's advances to closely-held corporation were not bad debts but produced long-term capital losses; corporation failed to repay and no attempt to collect; obligation subordinated to bonds); *Madeline Cook, T.C. Memo. 2000-253* (loans to son's catering business not business bad debt; protecting investment); *J. Michael Shedd, T.C. Memo. 2000-292* (transfer of funds was contribution to capital, not eligible for business bad debt deduction); *David E. Newman, T.C. Memo. 2000-345* (advances to joint venture not bona fide debt; no business bad debt deduction); *Brazaria County Stewart Fund, T.C. Memo. 2001-220* (no bad debt deduction for advances to related salvage equipment corporation; amounts were contributions to capital). See also *Bank of Kirksville v. United States, 943 F. Supp. 1191 (W.D. Mo. 1996)* (abuse of discretion by IRS in denying bad debt deduction claimed by local bank from loan charge-offs in 1980s).

- b. A corporation's bad debts are always considered business bad debts. See *Stemm v. United States, 152 F.3d 934 (11<sup>th</sup> Cir. 1998)* (not deductible bad debt because not wholly worthless).
2. A bad debt deduction may be taken for accounts and notes receivable only if the amount had been included in gross income for the current or prior taxable year. *Clair Worthington, T.C. Memo. 1999-11*; *Ferydoun Ahadpour, T.C. Memo. 2000-68*. See *John H. Douglas, T.C. Memo. 1998-165* (debt became uncollectible when debtors filed for bankruptcy).
    - a. Taxpayers on the cash method of accounting may not claim a bad debt deduction for payments not yet received or which they cannot collect. See *Treas. Reg. § 1.166-1(e)*.
    - b. Accrual method taxpayers may take a bad debt deduction for amounts owed if previously reported into income.
  3. If a creditor sells collateral for less than the amount of debt secured by the collateral and the remainder of the debt is uncollectible, the remainder may be deducted as a bad debt deduction if the uncollectible portion is capital or represents income previously reported by the creditor. *Treas. Reg. § 1.166-6(a)*.
    - a. However, if the creditor purchases the collateral for less than the fair market value of the collateral, the creditor realizes gain or loss to the extent of the difference between the amount of the obligation of the debtor applied to the purchase or bid price of the property and the property's fair market value. *Treas. Reg. § 1.166-6(b)*.
      - (1) The fair market value of the collateral is presumed to be the price bid by the purchasing creditor subject to clear and convincing proof to the contrary. *Treas. Reg. § 1.166-6(b)(2)*. See *Community Bank v. Commissioner, 819 F.2d 940 (9<sup>th</sup> Cir. 1987), aff'g, 79 T.C. 789 (1981)* (Commissioner allowed to present evidence of collateral's fair market value in excess of price bid by secured creditor).

#### C. Nonbusiness bad debts

1. Nonbusiness bad debts are bad debts not acquired or created in the course of operating a trade or business of the taxpayer or a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. *I.R.C. § 166(d)(2)*; *Friedman v Commissioner, 48 F.3d 535 (11<sup>th</sup> Cir. 1995)* (no business bad debt deduction for amounts paid on loan guarantee because not engaged in business of lending money or guaranteeing loans); *Coburn v. Commissioner, 205 F.3d 1345 (8<sup>th</sup> Cir. 1999)* (controlling shareholder not entitled to non-business bad debt deductions); *Warren J. Kidder, T.C. Memo. 1999-345 aff'd, 01-1 U.S.T.C. ¶ 50,258 (9<sup>th</sup> Cir. 2001)* (advances to wife's son not deductible as nonbusiness bad debt); *James J. Baggao, T.C. Memo. 1992-225* (dominant motivation was to protect investment; nonbusiness bad debt deduction allowed); *Silberstein v. United States, 93-1 U.S.T.C. ¶ 50,242 (E.D. Mo. 1993), aff'd, 16 F.3d 858 (8<sup>th</sup> Cir. 1994)* (primary motive for incurring debt was to protect investment in corporation); *Buchanan v. United States, 87 F.3d 197 (7<sup>th</sup> Cir. 1996)* (nonbusiness bad debt deduction not allowed); *Robert D. Schmidt, T.C. Memo. 1993-506* (loans to farm operation were non business bad debts; taxpayer not engaged in trade or business of being

- employee of farming operation; *John C. Smith, T.C. Memo. 1994-149* (purchase of property for inflated price at bankruptcy sale was deemed to be refinancing; no nonbusiness bad debt deduction); *Wayne R. Weber, T.C. Memo. 1994-341* (dominant motive was to protect investment; nonbusiness bad debt deduction allowed); *Loy E. Bowman, T.C. Memo. 1995-259* (advances to daughter were with intent of repayment; nonbusiness bad debt deduction allowed); *Reza Rezazadeh, T.C. Memo. 1996-245* (losses by employee-shareholder entitled to nonbusiness bad debt deduction); *Lee D. Froehlich, T.C. Memo. 1996-487* (dominant motive to protect investment; nonbusiness bad debt); *Kenneth R. Bauer, T.C. Memo. 1998-133* (nonbusiness bad debt deduction allowed; reasonable expectation of repayment); *Richard T. Stanley, Sr., T.C. Memo. 1999-20* (no evidence advances to controlled corporation were uncollectible); *Myer B. Barr, T.C. Memo. 1999-40* (bona fide debtor-creditor relationship established; deduction allowed); *Joseph F. German, T.C. Memo. 1999-104* (advances by farmer to corporations were equity capital; no bad debt deduction allowed); *August V. Klave, T.C. Memo. 1999-151* (advance of funds to inventor; non business bad debt deduction allowed); *Thomas O'Connell, T.C. Memo. 2001-158* (debt was to protect husband's investment; non business bad debt). See *William Spencer Bach, T.C. Memo. 1998-47* *aff'd*, 99-1 U.S.T.C. ¶ 50,550 (4<sup>th</sup> Cir. 1999) (bad debt deduction denied; no bona fide debt existed); *FSA 1993-0421-3, April 21, 1993* (no non-business bad debt deduction where wife satisfied joint liability which former spouse, now insolvent, agreed to pay).
2. To be deductible, nonbusiness bad debts must be totally worthless; partially worthless nonbusiness bad debts are not deductible. *Treas. Reg. § 1.166-5(a)*. See *Buchanan v. United States*, 87 F.3d 197 (7<sup>th</sup> Cir. 1996) (partial payment of debt by son-in-law showed debt had value even though payment came from embezzled funds and converted payroll tax trust funds); *Steven J. Scagliotta, T.C. Memo. 1996-498* (taxpayer expected to receive some distribution from bankruptcy estate; not worthless in year at issue); *Thomas A. Hayman, T.C. Memo. 1999-42* (deduction disallowed; debt did not become worthless during tax year in question).
  3. Nonbusiness bad debts are deductible only as short-term capital losses and are reported on Schedule D, Form 1040. *I.R.C. § 166(d)(1)(B)*.

#### D. Guarantees

1. If payment of another's debt is guaranteed, a bad debt deduction may be claimed by the guarantor if payment is made under the guarantee. A guaranteed obligation becomes worthless no earlier than when the guarantor pays the creditor. *Treas. Reg. § 1.166-9(a)*. See *Garner v. Commissioner*, 987 F.2d 267 (5<sup>th</sup> Cir. 1993) (guaranty was nonbusiness bad debt; dominant motive to protect salary, not investment in company); *Black Gold Energy Corp.*, 99 T.C. 482 (1992), *aff'd Unpub. Op.* (10<sup>th</sup> Cir. 4/8/94) (fact that guarantor was on accrual basis was irrelevant to timing of bad debt deduction).
  - a. Guarantees entered into after 1975 —
    - (1) To qualify for a deduction, guarantees entered into after 1975 must meet one of two conditions—
      - (a) The guarantee must have been entered into for profit with the guarantor receiving something in return.
      - (b) The guarantee must be related to the taxpayer's trade, business or employment. *Elliott v. Commissioner*, 98-2 U.S.T.C. ¶ 50,612 (8<sup>th</sup> Cir. 1998) (dominant motive in guaranteeing loan to protect investment; not business related); *Gaudio v. Commissioner*, 216 F.3d 524 (6<sup>th</sup> Cir. 2000) (bad debt deduction disallowed for S corporation shareholders as guarantors); *Webster Lair*, 95 T.C. 484 (1990) (farm indebtedness of son guaranteed by retired father did not meet either test for deductibility); *Pierce v. United States*, 90-2 U.S.T.C. ¶ 50,580 (E.D. Ark. 1990) (loans guaranteed by sole shareholder that were paid on default were short-term capital loans rather than business bad debt). See *Intergraph Corp. & Subs.*, 106 T.C. 312 (1996) (guarantor not entitled to bad debt deduction until right of subrogation shown to be worthless); *Larry M. Levy, T.C. Memo. 2001-136*

(guaranty payments not deductible as business bad debts; taxpayer not in business of acting as guarantor).

- (2) The loss may be either business or a nonbusiness bad debt depending upon the facts of the situation —
  - (a) To qualify as a business bad debt, the taxpayer must show that the reason for guaranteeing the debt was closely related to the taxpayer's trade or business. See *Barnes v. Commissioner*, 801 F.2d 984 (9<sup>th</sup> Cir. 1987), *aff'g*, T.C. Memo. 1985-456 (payment of guaranteed debt on behalf of taxpayer's corporation qualified only as nonbusiness bad debt where taxpayer incurred obligation in capacity as shareholder); *Litwin v. United States*, 983 F.2d 997 (10<sup>th</sup> Cir. 1993) (dominant motive in personal guarantee of corporation's line of credit was business; business bad debt deduction allowed).
  - (b) If the reason for making the guarantee was to protect the taxpayer's investment but not as part of the taxpayer's trade or business, a guarantee may give rise to a nonbusiness bad debt. See *In re Pierce*, 94-2 U.S.T.C. ¶ 50,627 (E.D. Okla. [Bkrpcy.] 1994) (dominant motive to protect investment, not to protect salary).
  - (c) Guarantees made as a favor to friends where the taxpayer received nothing in return do not give rise to a deduction. See *Webster Lair*, 95 T.C. 484 (1990) (guarantee of loan of taxpayer's son from bank for use in son's farming operation on land leased from taxpayer not eligible business or non-business bad debt deduction because debt between family members and made without consideration).

b. Guarantees entered into before 1976

- (1) A business bad debt deduction may be claimed for payments made under a guarantee if the following conditions are met—
    - (a) The borrowed funds are used in the borrower's trade or business, and
    - (b) The debt is totally worthless when paid off by the guarantor.
  - (2) If the above requirements are not met, it may be possible to treat the guarantee amount paid as a nonbusiness bad debt. I.R.C. § 166(f), *before amendment by Tax Reform Act of 1976*, § 605(c), *Pub. L. 94-455*. See *Manaharlal C. Parekh*, T.C. Memo. 1998-151 (nonbusiness bad debt, not deductible as business expense).
2. If the guarantor has a right of subrogation or other right over against another, a bad debt deduction cannot be claimed until those rights become worthless. The Claims Court has rejected the IRS position that a right of subrogation against a debtor must be retained by a creditor in order to claim a bad debt deduction from payment of a loan guarantee on behalf of the debtor. *Celanese Corp. & Consolidated Subsidiaries v. United States*, 85-2 U.S.T.C. ¶ 9517, 8 Cls. Ct. 456 (Cls. Ct. 1985).
  3. Since a guarantor is only secondarily liable and becomes liable only on the principal's default and notice, a release of the guarantor prior to becoming primarily liable does not appear to involve discharge of indebtedness income. *Ltr. Rul. 7953004*, September 7, 1979. See *Jerry S. Payne*, T.C. Memo. 1998-227 (release of guaranty obligation when not primary obligor; no discharge of indebtedness income). In the event a guarantor has become primarily liable, release of the guarantor produces discharge of indebtedness income. *Ltr. Rul. 8735065*, June 4, 1987 (parent co-signed note with child to help child purchase farmland; parent had discharge of indebtedness income when debt obligation compromised).
  4. A deduction may be available under I.R.C. § 163 for interest paid by a guarantor after the primary obligor's discharge in bankruptcy. *Stratmore v. Commissioner*, 785 F.2d 419 (3d Cir. 1986), *rev'g*,

*T.C. Memo. 1984-547. See R. G. Gregersen, T.C. Memo. 2000-325 (guarantor of promissory note became primarily liable and could deduct interest).*

5. Relief of a guarantor for liability may produce income. *Robert S. McDaniel, Jr., T.C. Memo. 1999-133 (capital gain on relief of liability as guarantor to partnership).*

#### E. Reporting bad debts

1. A bad debt deduction must be explained on the income tax return with a statement attached showing—
  - a. A description of the debt.
  - b. The name of the debtor.
  - c. The business or family relationship between the creditor and debtor, if any.
  - d. The date the debt became due.
  - e. Efforts made to collect the debt.
  - f. Basis upon which the decision was made that the debt was worthless.
2. For business bad debts, the amount claimed as a deduction should be reported on—
  - a. Form 1120 or Form 1120-S in the case of a corporation.
  - b. Form 1065 for partnership bad debts.
  - c. Form 1040 for bad debts in relation to a trade or business as an employee.
  - d. Schedule F, Form 1040 for bad debts from carrying on the business of farming as a sole proprietor.
  - e. Schedule C, Form 1040 for bad debts from carrying on a trade or business other than farming as a sole proprietor.
3. Nonbusiness bad debts for individuals are deducted on Schedule D, Form 1040, with the following notations—
  - a. Column (a)— enter “Bad Debt”.
  - b. Column (b)— enter “Worthless”.
  - c. Column (c)— enter the date the debt became worthless.
  - d. Column (d)—leave blank.
  - e. Column (e)— enter the amount of the debt that is worthless.
  - f. Column (f)— enter the deductible amount in parenthesis to show that it is a loss item.
4. Nonbusiness bad debts for partnerships are entered on Schedule D, Form 1065, in the same manner as shown above for Schedule D, Form 1040, for individuals.

## X. Recoveries from settlements and court judgments

- A. Recoveries from out-of-court settlements or as a result of judgments obtained may fall into any one of several categories—
1. Quite clearly, damages on account of personal injuries or sickness may be received tax-free. *Barbara Faye Leib, T.C. Memo. 1992-354* (damages representing back pay taxable; damages not taxable to extent representing personal injury from sex discrimination claim); *James R. Fitts, T.C. Memo. 1994-52, aff'd, 53 F.3d 335 (8<sup>th</sup> Cir. 1995)* (damages for misrepresentation in sale of business excludible); *Rev. Rul. 93-88, 1993-2 C.B. 61* (compensatory damages from racial or gender discrimination excludible but back pay to victim not excludible). See *Carl J. Fabry, 111 T.C. 305 (1998) rev'd, 223 F.3d 1261 (11<sup>th</sup> Cir. 2000)* (nursery owners who received damage award from chemical company for injury to business reputation for personal injury and excludible); *Henry v. Commissioner, 234 F.3d 34 (11<sup>th</sup> Cir. 2001)* (same); *Fred Henry, T.C. Memo. 2001-86* (settlement proceeds orchid grower received for damage to plants from fungicide not excludible; did not involve loss of business reputation as in *Fabry*); *Nancy Huff, T.C. Memo. 1995-200* (settlement in lawsuit divided between amount attributable to personal injury (excludible from income) and nonpersonal loss of investment (related to basis of property; involved collapse of horse-breeding syndication)).
    - a. Damages under the Age Discrimination in Employment Act (ADEA) are not excludible. *Robert Peaco, T.C. Memo. 2000-122* (settlement proceeds from age discrimination lawsuit not excludible). The U.S. Supreme Court reviewed a Fifth Circuit Court of Appeals decision in *Commissioner v. Schleier (Unpub. Op. in T.C. and Court of Appeals)* which had excluded an ADEA award from gross income. See *Jones v. Commissioner, 97-1 U.S.T.C. ¶ 50,402 (10<sup>th</sup> Cir. 1997)* (damages includible in income); *Manners v. United States, 99-2 U.S.T.C. ¶ 50,844 (Fed. Cl. 1998)* (same).
      - (1) The Supreme Court has held that the income is taxable. *115 S.Ct. 2159 (Sup. Ct. 1995)* (two part test for excludibility—(1) claim must be based on tort or tort-type rights and (2) damages received “on account of personal injury or sickness”). *Schmitz v. Commissioner, 34 F.3d 790 (9<sup>th</sup> Cir. 1994)* (underlying claim viewed as tort-like; amounts excludible). See *Downey v. Commissioner, 33 F.3d 836 (7<sup>th</sup> Cir. 1994), rev'g, 100 T.C. 634 (1993)*; *Fite v. Commissioner, 96-1 U.S.T.C. ¶ 50,159 (6<sup>th</sup> Cir. 1995)* (ADEA damages not excludible); *Lars E. Fredrickson, Jr., T.C. Memo. 1997-125, aff'd, 99-1 U.S.T.C. ¶ 50,167 (9<sup>th</sup> Cir. 1998)* (award in class action suit in settlement of sex discrimination claims not excludible); *Reina Martinez, T.C. Memo. 1997-126, aff'd, 99-1 U.S.T.C. ¶ 50,168 (9<sup>th</sup> Cir. 1998)* (same); *Dewey v. United States, 99-1 U.S.T.C. ¶ 50,375 (10<sup>th</sup> Cir. 1999)* (ADEA settlement not excludible); *Deborah E. Clark, T.C. Memo. 1997-156* (amounts received in settlement of sex discrimination lawsuit under Civil Rights Act of 1964 includible in gross income; no portion of award attributable to tort or tort-type rights); *John P. Raney, T.C. Memo. 1997-200* (same); *Neil S. Hardin, T.C. Memo. 1997-202* (same); *Tommy Jean Hayes, T.C. Memo. 1997-213* (same); *Fred Gillette, T.C. Memo. 1997-301* (same); *William Joseph Westmiller, T.C. Memo. 1998-140* (same); *Arnold Reisman, T.C. Memo. 2000-173* (ADEA settlement not excludible; as for state-level claims, no allocation between tort-type rights and other claims); *Ltr. Rul. 200041022, July 17, 2000* (damages received in settlement of sexual harrassment claim partly excludible (for pain and suffering and emotional distress) following physical attack).
      - (2) The opinion in *Schmitz v. Commissioner* has been vacated by the U.S. Supreme Court. *95-1 U.S.T.C. ¶ 50,322 (Sup. Ct. 1995)*. See also *Gates v. Commissioner, 95-2 U.S.T.C. ¶ 50,582 (10<sup>th</sup> Cir. 1995)* (recovery under ADEA not excludible); *McKay v Commissioner, 84 F.3d 433 (5<sup>th</sup> Cir. 1996)* (damages from state law wrongful discharge and breach of contract not excludable). Compare *Burke v. United States, 504 U.S. 229 (1992)* (interpreting older version of statute, circumscribed remedies did not evidence tort-like conception of personal injury).
      - (3) Legal fees incurred in connection with lawsuits leading to recovery are deductible only as miscellaneous itemized deductions. *Lars E. Fredrickson, Jr., T.C. Memo. 1997-125, aff'd, 99-1 U.S.T.C. ¶ 50,167 (9<sup>th</sup> Cir. 1998)* (Title VII suit); *Reina Martinez, T.C. Memo. 1997-126, aff'd, 99-1 U.S.T.C. ¶ 50,168 (9<sup>th</sup> Cir. 1998)* (same).

- b. Damages from employment discrimination are not excludible. *United States v. Stubblefield*, 94-2 U.S.T.C. ¶ 50,515 (S.D. Tex. 1994); *William J. Broedel*, T.C. Memo. 2001-135 (employment discrimination settlement not excludible). Compare *Alex M. Foster*, T.C. Memo. 1996-26, *aff'd*, 97-2 U.S.T.C. ¶ 50,687 (9<sup>th</sup> Cir. 1997), *cert. denied*, 10/5/98 (payments in settlement of employment dispute not excludible; settlement agreement lacked language that payments were on account of personal injuries); *Vu v. United States*, 00-1 U.S.T.C. ¶ 50,486 (D. Colo. 2000) (back pay for employment discrimination not excludible; before 1991 amendment); *John W. Banks III*, T.C. Memo. 2001-48 (same).
- c. Amounts received in settlement of an ERISA action are not excludible inasmuch as ERISA does not provide a tort-like remedy. *Hemelt v. United States*, 122 F.3d 204 (4<sup>th</sup> Cir. 1997) (ERISA relief only equitable in nature); *Mayberry v. United States*, 151 F.3d 855 (8<sup>th</sup> Cir. 1998) (same). See *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993) (only equitable relief under ERISA). But see *Dotson v. United States*, 95-1 U.S.T.C. ¶ 50,258 (S.D. Tex. 1995), *rev'd*, 87 F.3d 682 (5<sup>th</sup> Cir. 1996); *Gerbec v. United States*, 164 F.3d 1015 (6<sup>th</sup> Cir. 1999).
- d. As the regulations point out, non-taxable damages include “an amount received (other than workmen’s compensation) through prosecution of a legal suit or action based on tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution”. *Treas. Reg. § 1.104-1(c)*. *Green v. Commissioner*, 99-2 U.S.T.C. ¶ 50,999 (10<sup>th</sup> Cir. 1999) (breach of contract recovery not excludible; alleged wrongful termination); *Taylor v. Commissioner*, 01-1 U.S.T.C. ¶ 50,154 (9<sup>th</sup> Cir. 2000) (settlement for on-the-job injury not excludible; no allocation to tortious injury); *Boyett Coffee Co. v. United States*, 775 F. Supp. 1007 (W.D. Tex. 1991) (settlement proceeds not excludible from income as personal injury damages; taxpayer failed to present credible evidence of “tort-type” injury for loss of business reputation). See *Cook v. United States*, 00-2 U.S.T.C. ¶ 50,770 (Fed. Cir. 2000); *Gary A. Simko*, T.C. Memo. 1997-9 (same); *Julius R. Phillips*, T.C. Memo. 1997-336 (lump sum payment upon termination of employment deemed severance pay and not excludible even though age discrimination alleged); *William Roger Thorpe*, T.C. Memo. 1997-342 (same); *Neil D. Lubart*, T.C. Memo. 1997-343 (same); *Joseph J. Gajda*, T.C. Memo. 1997-345, *aff'd*, 156 F.3d 182 (5<sup>th</sup> Cir. 1998) (same); *Joyce M. Hamm*, T.C. Memo. 1997-358 (same). See also *Greer v. United States*, 98-2 U.S.T.C. ¶ 50,821 (E.D. Ky. 1998) *rev'd*, 207 F.3d 322 (6<sup>th</sup> Cir. 2000), *on remand*, 01-1 U.S.T.C. ¶ 50,377 (E.D. Ky. 2001) (severance payments divided between excludible amount for personal injuries and wrongful discharge and taxable amount); *Banks v. United States*, 94-2 U.S.T.C. ¶ 50,630 (W.D. Wash. 1994) (claim of employee against union for breach of duty of fair representation was tort-like and excludible from gross income); *George Knevelbaard*, T.C. Memo. 1997-330 (payments received by dairy farmers from bonds in settlement of lawsuit against dairy professor and distributor for default on contractual obligation to pay for delivered milk excludible as based on tort or tort-type rights; settlement proceeds paid on account of emotional harm to farmers); *F. Browne Gregg, Sr.*, T.C. Memo. 1999-10 (jury award not based on personal injury); *Allen Burditt II*, T.C. Memo. 1999-117 (allocation language not negotiated at arms length; payments partially excludible); *Estate of Schoeneman*, T.C. Memo. 2000-161 (settlement payment excludible; underlying nature of claim settled involved personal injuries); *Holland v. United States*, 94 F. Supp. 2d 787 (S.D. Tex. 2000) *aff'd*, 01-1 U.S.T.C. ¶ 50,291 (5<sup>th</sup> Cir. 2001) (nuisance recovery by trust beneficiary not excludible); *Marenin v. United States*, 00-2 U.S.T.C. ¶ 50,689 (N.D. Calif. 2000) (severance pay not excludible as wage discrimination claim); *Debra S. Dickerson*, T.C. Memo. 2001-53 (personal injury settlement not excludible from gross income; no discernible portion of recovery paid on account of personal injury or sickness); *Richard W. Waters*, T.C. Summary Opinion 2001-46 (settlement payment for overtime compensation, liquidated damages and attorney fees not excludible); *Brian David Nelson*, T.C. Summary Opinion 2001-44 (proceeds from unfair labor standards class action not excludible; award not intended to compensate for personal injury or sickness); *Michael R. Fawcett*, T.C. Summary Opinion 2001-65 (same); *Kevin W. Hamblin*, T.C. Summary Opinion 2001-73 (same); *Richard J. Tritz*, T.C. Summary Opinion 2001-76 (termination payment not excludible); *James E. Norris*, T.C. Memo. 2001-152 (disability retirement benefits not excludible from income under workers’ compensation act or statute in nature of workers’ compensation); *James K. Goodchild*, T.C. Summary Opinion 2001-102 (disability benefits computed on basis of period of absence from work not excludible). See *Ltr. Rul. 200116040*, January 23, 2001 (statute in nature of workers’

compensation; payments excludible); *Ltr. Rul. 200121031, February 16, 2001* (amounts received in settlement of asbestos claims excludible; physical disease sustained).

- e. However, interest on damages for personal injury or sickness is not excludible. *Brabson v. United States, 73 F.3d 1040 (10<sup>th</sup> Cir. 1996)* (prejudgment interest on damages from explosion caused by gas leak); *Rice v. United States, 834 F. Supp. 1241 (E.D. Calif. 1993)* (punitive damages also taxable income although regular damages excludible). See *R. S. Kovacs, 100 T.C. 124 (1993), aff'd Unpub. Op. (6<sup>th</sup> Cir. 6/6/94)* (statutorily-imposed interest). See also *Delaney v. Commissioner, 99 F.3d 20 (1<sup>st</sup> Cir. 1996)* (39 percent of settlement in negligence action apportioned to prejudgment interest which was taxable); *Rozpad v. Commissioner, 154 F.3d 1 (1<sup>st</sup> Cir. 1998)* (pre-judgment interest in medical malpractice settlement taxable); *Michael J. Woods, T.C. Memo. 1998-435* (same); *Joseph M. Perry, T.C. Memo. 1998-433* (prejudgment interest taxable); *Manuel J. Serpa, Jr., T.C. Memo. 1998-453* (same); *Francisco v. United States, 54 F. Supp. 2d 427 (E.D. Pa. 1999)* (delay damages, basically pre-judgment interest, not excludible from auto accident); *Yaney D. Greer, T.C. Memo. 2000-25* (compulsory interest received in medical malpractice suit includible in gross income).
- f. Validity of settlement agreements—
  - (1) Agreements which are silent as to the portion attributable to excludible damages produce taxable income. *Taggi v. United States, 835 F. Supp. 744 (S.D. N.Y. 1993, aff'd, 35 F.3d 93 (2d Cir. 1994)* (termination payment represented waiver of right to seek compensation for injury). See *Fred Henry, T.C. Memo. 1997-460* (implication that payment to orchid grower by manufacturer and distributor was pursuant to settlement agreement and so not excludible from income).
  - (2) Settlement agreements not entered into in an adversarial context at arm's length and in good faith may be disregarded. *Lance R. LeFleur, T.C. Memo. 1997-312* (payments not received on account of personal injury).
  - (3) Releases—
    - (a) Releases relinquishing existing claims against an employer may resemble severance pay more than a settlement and be nondeductible even though a tort-type cause of action may be released. *Michael M. Brennan, T.C. Memo. 1997-317* (lump sum payment). See *Gajda v. Commissioner, 156 F.3d 182 (5<sup>th</sup> Cir. 1998)* (employee required to sign standard form of general release of liability under voluntary severance program; includible in gross income); *Ball v. Commissioner, 163 F.3d 308 (5<sup>th</sup> Cir. 1998)* (separation agreement not excludible); *Abbott v. United States, 76 F. Supp. 2d 236 (N.D. N.Y. 1999), aff'd, 00-2 U.S.T.C. ¶ 50,819 (2d Cir. 2000)* (payments to downsized employees not excludible; not tort-like in nature); *Darrell D. Moran, T.C. Memo. 1997-412* (agreement designated payments as "severance pay" with no allocation of damages and taxpayer failed to establish pay was compensation for personal injury). See also *Allen L. Carey, T.C. Memo. 1997-434* (lump sum payment not excludible; taxpayer failed to show payment allocable to tort-type damages); *William J. Goeden, T.C. Memo. 1998-18* (termination payments allocated in part to excludable payments on account of personal injuries and to taxable payments for other claims); *Edward W. Reiher, T.C. Memo. 1998-75* (settlement payment in settlement of gender discrimination suit not excluded from income); *Stephen William Dahlgren, T.C. Memo. 1998-32* (employment termination payment was taxable severance pay); *Joann Thompson, T.C. Memo. 1998-214* (severance pay includible in gross income; no evidence in record that lump-sum payment was to compensate for tort-like injuries); *Pipitone v. United States, 98-2 U.S.T.C. ¶ 50,714 (N.D. Ill. 1998) aff'd, 180 F.3d 859 (7<sup>th</sup> Cir. 1999)* (same); *Cook v. United States, 00-2 U.S.T.C. ¶ 50,770 (Fed. Cir. 2000), cert. applied for 5/29/01* (lump-sum payment pursuant to exit-incentive program by IBM not excludible); *Walter E. Hess, T.C. Memo. 1998-240* (proceeds of settlement not allocable to tort-like personal injury); *Aschkenasy v. United States, 98-2 U.S.T.C. ¶ 50,634 (S.D. N.Y. 1998)* (payment under voluntary severance program includible even though employee

required to sign general release of liability); *James J. Harford, T.C. Memo. 1998-392* (lump sum payment on resignation of employment not excludible; execution of release from liability did not confirm existence of cause of action against employer); *Richard Sherman, T.C. Memo. 1999-202* (settlement includible in income; not excludible as tort-type damages in settlement of personal injury/age claims); *Salvatore J. D'Amico, T.C. Memo. 1999-374* (amounts paid under settlement agreement with former employer not excludible; not paid on account of tort or tort-type rights alleging personal injury or sickness); *William A. Jacobs, T.C. Memo. 2000-59* (settlement proceeds under Fair Labor Standards Act (overtime) not excludible); *Ronald N. Gross, T.C. Memo. 2000-342* (severance payments received by accountant not excludible although two lump sum payments under defamation and age discrimination claims excludible); *Richard M. Managan, T.C. Memo. 2001-192* (settlement for wrongful termination claim not excludible).

- (b) However, settlement proceeds involving personal injury may be excludible. *Alain Massot, T.C. Memo. 2000-24* (personal injury on account of discharge). However, if not based on personal injury, settlement payments are not excludible. *Marsha M. Bland, T.C. Memo. 2000-98* (payment received in connection with termination of employment related to sexual harassment not excludible; payment in return for general release); *Nancy J. Hukkanen-Campbell, T.C. Memo. 2000-180* (damages from sexual harassment not excludible); *Joseph H. Metelski, T.C. Memo. 2000-95, aff'd, 01-2 U.S.T.C. ¶ 50,482 (3d Cir. 2001)* (lump sum payment in nature of severance pay includible in income; waiver of right to sue not sufficient to make it tort-type settlement); *Francis G. Laguaito, T.C. Memo. 2000-103* (compensation on termination of employment not excludible even though general release signed); *Richard D. Anderson, T.C. Memo. 2000-344* (\$1 received for slander excludible; amounts received for economic injuries (tortious interference with business) not excludible).

(4) Attorney's fees —

- (a) Legal fees paid to the taxpayer's attorney and withheld from the settlement check are includible in the taxpayer's income. *Eldon R. Kenseth, 114 T.C. 399 (2000), aff'd, 01-2 U.S.T.C. ¶ 50,570 (7th Cir. 2001)* (contingency fee includible in taxpayer's gross income with attorneys' fees deductible as miscellaneous itemized deductions subject to two percent floor; *Clarks* and *Cotnam* cases not followed); *Ltr. Rul. 9809053, December 2, 1997* (gender and age discrimination lawsuit; fees paid under contingency fee arrangement). See *Franklin P. Coady, T.C. Memo. 1998-291 aff'd, 00-1 U.S.T.C. ¶ 50,528 (9th Cir. 2000), cert. denied, 121 U.S. 1604 (2001)* (wrongful termination suit; fees under contingency fee agreement not excludible; court rejected argument that attorney had a property interest in the action); *Baylin v. United States, 43 F.3d 1451 (Fed. Cir. 1995)*; *Alexander v. Internal Revenue Service, 72 F.3d 938 (1st Cir. 1995)*; *Benci-Woodward v. Commissioner, 219 F.3d 941 (9th Cir. 2000), cert. denied, 121 S. Ct. 855 (2001)* (portion of punitive damage award retained by attorneys includible in taxpayer's income; under California law, attorney's lien does not confer ownership interest); *James T. Sinyard, T.C. Memo. 1998-364* (age discrimination suit; full amount taxable to client); *Nancy J. Hukkanen-Campbell, T.C. Memo. 2000-180* (contingency fee portion of settlement taxed to individual). See also *Brewer v. Commissioner, 99-1 U.S.T.C. ¶ 50,378 (9th Cir. 1999)* (amount paid directly to attorney as legal fees not excludible from income); *Andrew S. Brenner, T.C. Memo. 2001-127* (legal fees for terminated employee in settlement of claims were miscellaneous itemized deductions and includible in calculating alternative minimum tax).
- (b) However, some courts have allowed the portion of an attorney's contingency fee paid to the attorney to be excludible from income. *Estate of Clarks, 202 F.3d 854 (6th Cir. 2000)* (contingency fees are property of attorney; not taxable to client); *Brisco v. United States, 01-1 U.S.T.C. ¶ 50,420 (6th Cir. 2001)* (interest earned on attorney's contingency fee could be excluded from income; involved personal injuries); *Sudhir P. Srivastava, T.C. Memo. 1998-362, rev'd, 220 F.3d 353 (5th Cir. 2000)* (attorney had common law lien

under Texas law); *Cotnam v. Commissioner*, 263 F.2d 119 (5<sup>th</sup> Cir. 1959); *Willa Mae Barlow Davis, T.C. Memo. 1998-248*, *aff'd*, 210 F.3d 1346 (11<sup>th</sup> Cir. 2000) (*Cotnam v. Comm'r*, *supra*, followed; involved same jurisdiction); *Wade H. Griffin, III, T.C. Memo. 2001-5* (*Cotnam v. Comm'r*, *supra*, followed).

- (5) Corporations cannot suffer personal injury so proceeds from settlement of a lawsuit are not excludible. *P&X Markets, Inc. v. Commissioner*, 98-2 U.S.T.C. ¶ 50,613 (9<sup>th</sup> Cir. 1998) (corporation argued sole shareholder suffered consequences).
- g. Punitive damages appear to be includible in gross income. *Commissioner v. Miller*, 914 F.2d 586 (4<sup>th</sup> Cir. 1990); *Reese v. United States*, 24 F.3d 228 (Fed. Cir. 1994); *Hawkins v. United States*, 30 F.3d 1077 (9<sup>th</sup> Cir. 1994); *Moore v. Commissioner*, 53 F.3d 712 (5<sup>th</sup> Cir. 1995); *Rice v. United States*, 834 F. Supp. 1241 (E.D. Calif. 1993). See *Wesson v. United States*, 48 F.3d 894 (5<sup>th</sup> Cir. 1995) (punitive damages for bad faith action against insurance company not excludible); *Robinson v. Commissioner*, 70 F.3d 34 (5<sup>th</sup> Cir. 1995) (punitive damages obtained from bank for failure to release lien not excludible); *Brabson v. United States*, 73 F.3d 1040 (10<sup>th</sup> Cir. 1996) (prejudgment interest on damages from explosion caused by gas leak); *Willa Mae Barlow Davis, T.C. Memo. 1998-248*, *aff'd*, 210 F.3d 1346 (11<sup>th</sup> Cir. 2000) (punitive damages in civil suit for refusal to cancel report contract taxable); *Norris O. Whitley, T.C. Memo. 1999-124* (punitive damages includible in gross income; not compensatory under state law); *George W. Guill*, 112 T.C. 325 (1999) (punitive damages includible; litigation costs attributable to recovery of punitive damages deductible); *David S. Brandriet, T.C. Memo. 2000-302* (punitive damages as result of negligence action included in income); *Ltr. Rul. 9922056, January 25, 1999* (post judgment interest on punitive damage award includible in income in year paid). But see *Horton v. Commissioner*, 100 T.C. 93 (1993), *aff'd*, 33 F.3d 625 (6<sup>th</sup> Cir. 1994). *Horton v. Commissioner, supra*, will no longer be followed by the Tax Court. *Hughes A. Bagley*, 105 T.C. 396 (1995), *aff'd*, 121 F.3d 393 (8<sup>th</sup> Cir. 1997) (part of settlement agreement involving tortious interference with employment, libel and invasion of privacy consisted of settlement of corporation's liability for punitive damages and was includible in income). The U.S. Supreme Court has held that a punitive damages award for death from toxic shock syndrome was not excludible from gross income. *O'Gilvie v. United States*, 117 S. Ct. 452 (*Sup. Ct. 1996*) (damages not received "on account of" personal injury).
- h. In 1996, Congress specified that the exclusion for personal injury or "tort-like" damages does not apply to punitive damages or to damages not attributable to physical injury or physical sickness. *Pub. L. 104-188, Sec. 1605(a)*, amending *I.R.C. § 104(a)(2)*, effective for payments received after August 21, 1996. See *Rev. Rul. 96-65, 1996-2 C.B. 6* (back pay includible in gross income is subject to FICA, FUTA, and RRTA).
- i. Settlement proceeds allocable to a mental distress claim are excludible from gross income. *E. Pauline Barnes, T.C. Memo. 1997-25*.
- j. If a claim would be excludible, legal expenses are not deductible. *Larry D. Land, T.C. Summary Opinion 2001-111* (attempt to deduct legal expenses on Schedule F).
2. For recoveries in connection with a business, if the taxpayer can prove that the damages received were for injury to capital, no income results except to the extent damages exceed the income tax basis of the capital asset involved. The recovery is, in general, a taxable event except to the extent the amount recovered represents a return of basis. See *Ltr. Rul. 8802032, October 15, 1987* (settlement of suit by bankruptcy trustee for return of funds invested by debtor in grain storage facility did not result in ordinary income except to extent settlement amount exceeded debtor's basis in facility). See *Every v. United States*, 95-1 U.S.T.C. ¶ 50,229 (9<sup>th</sup> Cir. 1995) (recovery from oil spill related to business loss, not compensation for personal injuries).
3. Recoveries representing a reimbursement for lost profit are taxable as ordinary income. *E.g., Raytheon Prod'n Corp. v. Commissioner*, 144 F.2d 110 (1<sup>st</sup> Cir.), *cert. denied*, 323 U.S. 779 (1944) (recovery in antitrust action for destruction of good will includible in gross income; no basis established for good will).

- B. Most actions brought by a farmer against a lender involve an element of lost profit and some involve recovery of basis. Therefore, rules 2 and 3 above tend to govern.
- C. The proper characterization of recoveries is vitally important. There may be discharge of indebtedness involved and, in some instances, the transaction may be characterized as a “sale” of property to the creditor.