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42nd Annual Alexander L. Paskay Memorial Bankruptcy Seminar

Clash of the Codes: Bankruptcy Tax Issues Made Simple

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Effectively Discharging Taxes in Bankruptcy

PRESENTED BY
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And

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TAX VS. BANKRUPTCY IMPORTANT DIFFERENCES

- ▶ 1. BK exemptions N/A to Tax World (e.g. “homestead” means nothing).
- ▶ 2. Tax Debts are “consumer” debts for the “means test” (yeah!)
- ▶ 3. NEVER file an Adversary Proceeding vs. IRS. (Instead, let Insolvency Unit handle it administratively).
- ▶ 4. 60 days post-discharge, call Insolvency Unit (800-973-0424) to confirm discharge and negotiate “buy-out” of FTL (as little as 10-15% of value of equity).
- ▶ 5. IRAs, retirement plans are not exempt but IRS almost never seizes them. Call their bluff when they ask debtor to liquidate them.

Initial classification of tax debts

1. Bifurcate: Secured vs. Unsecured

If a tax debt is otherwise dischargeable but is secured, what's the point?

The lien stays attached to the equity post-Discharge.

2. Then Trifurcate Unsecured into:

Priority vs. Non-Priority vs. Not Dischargeable

3. The Unsecured, Non-Priority is “Nirvana”!

SECURED TAX DEBTS

A tax debt of any type is “secured” if:

- A Notice of Federal Tax Lien (FTL) has been properly filed;
- With respect to which there are one or more assets of the taxpayer; and
- In which there is equity, but is “secured” only to the extent of the equity.
- (For real estate, FTL must be filed in same county).

PRIORITY TAX DEBTS

Section 507 (a) (8) of the Bankruptcy Code provides that the following are “priority” taxes (declared by Section 523 (a)(1)(A) to be *not dischargeable* in a Chapter 7)

- ▶ “Newer” income taxes
- ▶ Trust Fund Taxes
- ▶ Unassessed Taxes

“NO DISCHARGE” TAX DEBTS

- ▶ No Discharge is given for a tax obligation:
 - ▶ For which tax returns have not been filed (SFR not a return)
 - ▶ For which tax returns were filed late but within the 2 years* preceding the bankruptcy; or
 - ▶ On returns that were either:
 - ▶ Filed fraudulently, or
 - ▶ With respect to which the debtor willfully attempted to evade or defeat the tax due and owing

*Tax debts from returns filed within the previous 2 years can “age” into non-priority (dischargeable!) once they

NON-PRIORITY (DISCHARGEABLE) TAXES

Basically, this means unsecured income taxes are dischargeable if:

- A ***“return” was filed*** (an SFR return is not a return for this, but some SFR taxes may be if an actual return was filed before SFR assessment made (complicated));
- The returns were ***filed more than 2 years ago***;
- The returns were ***due (with extensions) more than 3 years ago***;
- The taxes were ***assessed more than 240 days ago***; AND
- there was ***no fraud or willful evasion*** in connection with the returns.

TOLLING

- ▶ Various time periods are suspended or “tolled” if one or more of certain events occurs or continues during the subject time period.
- ▶ Prior to BAPCPA, the United States Supreme Court held in *Young v. United States*, 535 US 43 (2002), that the 3-year look back provision was “equitably tolled” during the debtor’s previous bankruptcy.

TOLLING

BAPCPA codified the concept of “tolling” in “flush language” found immediately after 11 USC 507 (a)(8)(G), which provides that

“an otherwise applicable time period....shall be suspended for any period...”during which the government is prohibited under non-bankruptcy law from collecting a tax due to the taxpayer’s timely request for a CDP Hearing (plus any appeal), plus 90 days, plus any time during which a prior bankruptcy was in effect, plus 90 days.”

These tolling rules apply to the 3-yr and 240-day rules.

SPECIAL TOLLING RULE FOR OIC’s

While the tolling for a timely CDP and a prior BK toll both the 3-year and the 240-day tests, there’s an additional tolling event for OICs (offers to settle, or Offers in Compromise).

If the OIC is filed within 240 days after the assessment is made, the 240-day rule is further tolled for the period the OIC is under consideration (plus appeals), plus 30 days.

DOES TOLLING APPLY TO THE 2-YEAR RULE OF 11 USC 523(a)(1)(B)(ii)?

Because the codified tolling provisions are found only in 11 USC 507, most commentators do not believe that the tolling rules apply to the 2-year rule found in 11 USC 523 (a)(1)(B)(ii).

But see *Putnam V. United States*, (Bankruptcy E.D.N.C. January 2014).

IRS believes that *Young's* equitable tolling applies to the 2-year rule and so IRS applies tolling to 523 as well!

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gives the user the option to have tolling apply to the 2-yr rule, or not. Options!

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CLASSIFICATION OF TAX DEBTS IN BANKRUPTCY

- ▶ Unsecured, Non-Priority Tax Debts: are fully dischargeable in a chapter 7 bankruptcy and are treated as general, unsecured debts in a chapter 13 proceeding.
- ▶ Unsecured, Priority Tax Debts: are not dischargeable in a chapter 7 (they survive the bankruptcy) and must be paid in full in a chapter 13 but without the further accrual of penalties or interest (to the extent unsecured; otherwise, minimal interest).
- ▶ Secured Tax Debts: are not dischargeable



Clash of the Codes: Chapter 11 Bankruptcy Tax Issues Made Simple

42nd Annual Alexander L. Paskay Memorial Bankruptcy Seminar

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Bryan Glazer Family JCC • Tampa, Florida

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Post-Petition Tax Obligations of Chapter 11 Debtor

- ▶ No separate taxable entity is created upon the filing of bankruptcy by a Chapter 11 debtor.
- ▶ Income tax obligations arising post-petition are treated as administrative expense claims
 - ▶ Issue—what about taxes for income generated pre-petition, where liability is assessed post-petition?
 - ▶ *In re Hillsborough Holdings Corp.*, 156 B.R. 318, 320 (Bankr. M.D. Fla. 1993), subsequently aff'd, 116 F.3d 1391 (11th Cir. 1997) (“[T]o the extent that income is not earned by the estate during the case, but is instead earned by the pre-petition debtor, any tax liability on that income is not entitled to an administrative expense priority.”); see also *In re Goody's LLC*, 508 B.R. 891, 900 (Bankr. D. Del. 2014) (citing *Hillsborough Holdings* and holding that employment taxes for pre-petition wages were not administrative expense claims)
 - ▶ See also Section 507(a)(8) of the Bankruptcy Code which limits prepetition priority income tax claims for a taxable year ending on or before the date of the filing of the bankruptcy petition. These taxes are payable in accordance with the terms of the confirmed plan.
 - ▶ Issue-interest on post-petition taxes - majority of courts say interest is an administrative expense claim
- ▶ Chapter 11 debtor must timely file post-petition tax returns.
 - ▶ IRC § 6012(b)(3)—Bankruptcy trustee (and debtor-in-possession) required to file tax returns
 - ▶ 11 U.S.C. § 1112(b)(4)(I)—Dismissal or conversion of Chapter 11 case for cause is warranted for failure of debtor to file post-petition tax returns or timely pay post-petition taxes
- ▶ Filing of a corporate bankruptcy case does not create a separate taxable entity. IRC § 1399.
- ▶ Section 346 of the Bankruptcy Code essentially provides for the same requirements with respect to state and local taxes.
- ▶ Middle District of Florida - In order authorizing debtor in possession to operate its business, the Bankruptcy Court requires that (i) all delinquent state or federal tax returns be filed within 30 days² after entry of the order, and (ii) the debtor timely file all post-petition federal and state tax returns and timely pay all post-petition federal and state taxes.

Discussion of Tax Consequences in Chapter 11 Disclosure Statements

Pre-BAPCPA:

- ▶ *In re Metrocraft Publ'g Servs.*, 39 B.R. 567, 568 (Bankr.N.D.Ga.1984) (listing non-exhaustive list of factors that should be disclosed, including “(18) tax attributes of the debtor...”).

BAPCPA (2005) added new explicit requirement that Chapter 11 disclosure statements must discuss federal tax consequences of plan.

Section 1125(a)(1) provides that a disclosure statement for a chapter 11 plan must include:

a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such a hypothetical investor of the relevant class to make an informed judgment about the plan

11 U.S.C. § 1125(a)(1).

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WHAT DOES THIS MEAN?

While there are not many reported cases on adequate information in a disclosure statement in the context of discussing tax consequences, the few cases that have discussed this issue generally agree that:

- ▶ Disclosure statement must do more than simply “describe[] generally how tax law works in a few sentences.” *In re Pac. Shores Dev., Inc.*, No. BR 10-11351MM-11, 2011 WL 778205, at *5 (Bankr. S.D. Cal. Feb. 25, 2011).
- ▶ Debtor cannot simply direct creditors to consult with their own tax advisors as to the potential consequences of a plan. *In re Divine Ripe, L.L.C.*, 554 B.R. 395, 412 (Bankr. S.D. Tex. 2016).
- ▶ A discussion should not be vague and noncommittal regarding tax consequences of the plan on the debtor and creditors. *Divine Ripe*.

One case even found a plan proponent (bank) liable for negligent misrepresentation for its failure to investigate the tax consequences of the plan. *Smith v. Bank of New York*, 161 B.R. 302, 307 (Bankr. S.D. Fla. 1993).

See also, *In re Zaruba*, 384 B.R. 254, 256-57 (Bankr. D. Alaska 2008) (disclosure that “Debtors have been advised that there will be no adverse tax consequences as a result of the transactions proposed in this plan” inadequate information).

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DRAFTING CONSIDERATIONS

- ▶ In what situations should you go beyond a “boilerplate” provision?
- ▶ Should you routinely consult with a CPA in drafting the disclosure statement tax consequences section?
- ▶ How could an objection be dealt with?
 - ▶ affidavit of CPA
 - ▶ amend disclosure on a case by case basis

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Principal Purpose of Plan cannot be Tax Avoidance

Section 1129(d) provides:

Notwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes [T]he governmental unit has the burden of proof on the issue of avoidance.

Corresponding IRC provision, 26 U.S.C. § 269:

(a) In general.--If--

(1) any person or persons acquire, directly or indirectly, control of a corporation, or

(2) any corporation acquires, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

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IRC provision, 26 U.S.C. § 269 (continued)

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

Example 1:

- ▶ Debtor sells substantially all of its assets post-confirmation;
- ▶ The sale is expected to produce substantial income tax liability for the estate; and
- ▶ The plan does not provide for payment of this expected income tax liability.
- ▶ See *In re Scott Cable Commc'ns, Inc.*, 227 B.R. 596, 603 (Bankr. D. Conn. 1998).

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IRC provision, 26 U.S.C. § 269 (continued)

Example 2:

- ▶ Debtor has substantial net operating losses but is not operating and has no other assets;
- ▶ Plan provides for sale of debtor's stock to a related company with common ownership; and
- ▶ Following purchase, stock purchaser would (presumably) transfer capital to its newly acquired subsidiary to allow it to generate income against which it could offset net operating losses.

In re S. Beach Sec., Inc., 606 F.3d 366 (7th Cir. 2010) (denying confirmation of chapter 11 plan under Section 1129(d) and also for lack of good faith under Section 1129(a)(3)). Note that *South Beach Securities* had a number of unsavory facts. Judge Posner actually directed the US Trustee to "consider applying for sanctions against Scattered and South Beach, Greenblatt, the appellants' law firms, and the firms' lawyers who worked on the case, for misconduct in the bankruptcy and district courts." *Id.* at 378

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TAX ISSUES: SALE OF ASSETS IN AN ENTITY CHAPTER 11 CASE

- ▶ Section 363 of the Bankruptcy Code governs a sale of a debtor's assets outside the ordinary course of business and involves a sale of all, substantially all, or less than substantially all of such assets
- ▶ Sale of a debtor's assets can also occur pursuant to a confirmed plan
- ▶ Tax consequences of a sale can have a major impact on a debtor, a debtor's creditors, and a purchaser
- ▶ Section 363 asset sales are usually taxable to the debtor/seller
- ▶ Initial due diligence by counsel for debtor and purchaser as to debtor's tax status and history is critical
- ▶ Under Section 363(f) of the Bankruptcy Code, a sale free and clear of interests typically shields a buyer from any successor liability tax claims where there has been adequate and proper notice of a sale. Thus, all applicable taxing authorities should receive notice of the sale.
- ▶ What happens where the debtor does not have sufficient cash proceeds after the closing to pay federal income taxes resulting from the sale? See *In re ICL Holding Company, Inc.*, 802 F.3d 547 (3d Cir. 2015)

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Tax Issues (continued)

- ▶ Key tax issues in negotiation of asset purchase agreement:
 - ▶ Debtor's counsel should conduct a pre-petition title and tax lien search for filed tax liens
 - ▶ Representations and warranties to be provided by the debtor as to tax returns and taxes - these are typically required by a sophisticated purchaser due to successor liability concerns and claims under indemnification provision in favor of the purchaser
 - ▶ Debtor's counsel needs to check county tax records to determine payment status of ad valorem real estate taxes and personal property taxes
 - ▶ Proration for ad valorem real estate taxes and personal property taxes - should a debtor agree to a re-proration once the actual tax assessments are issued by the county?
 - ▶ Inclusion of Section 1146(a) exemption language in court order, transfer documents and debt instruments (see further discussion below)
 - ▶ Purchase price allocation provision for IRS purposes - negotiate before or after closing?
 - ▶ Responsibility for filing tax returns post-closing
 - ▶ Indemnification provisions relating to tax matters
 - ▶ Florida - request for sales tax clearance certificate from the Florida Department of Revenue

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TYPES OF TAXES

- ▶ **Federal - Internal Revenue Service**
 - ▶ Determination of post-petition administrative expense claims
 - ▶ Determination of secured claims
 - ▶ Determination of priority claims under Section 507(a)(8)
 - ▶ Treatment of penalties - priority or general unsecured claims?
- ▶ **State - Florida Department of Revenue**
 - ▶ Sales taxes
 - ▶ Documentary stamp taxes
 - ▶ Intangible taxes
- ▶ **County**
 - ▶ Ad valorem real estate taxes
 - ▶ Personal property taxes
 - ▶ Tax deed certificates

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Determination of Taxes for Closing

- ▶ Need to make adequate provision for all taxes
- ▶ Need to account for post-petition IRS tax claims, which are administrative expense claims, and accrual of interest thereon
- ▶ Dilemma arises if governmental unit bar date has not yet occurred
 - ▶ Bar date is 180 days after petition date
 - ▶ Can motion be filed to force governmental units to file proof of claims earlier?
 - ▶ Need to account for post-petition accrual of interest on past due real property and personal property taxes

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Treatment of Federal Income Taxes in Bankruptcy

- ▶ Income taxes that are administrative expense claims must be paid in full on the effective date of a Chapter 11 plan
- ▶ Pursuant to Section 1129(a)(9)(C), pre-petition income taxes under Section 507(a)(8) must be paid under a confirmed plan in regular installment payments, in cash, (i) over a period ending not later than 5 years after the petition date, and (ii) in a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan
- ▶ Pursuant to Section 1129(a)(9)(D), a secured tax claim that would otherwise meet the description of a tax claim under Section 507(a)(8) must be paid in the same manner as provided under Section 1129(a)(9)(C)
 - ▶ Exception: in a sale of assets in a Chapter 11 case, secured tax claims will need to be paid in full at closing in order for the debtor to deliver clean title as to the assets to be sold to the purchaser

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TRANSFER TAX EXEMPTIONS

- ▶ Section 1146(a) of the Bankruptcy Code states “[t]he issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax.” [Note: Section 1146(a) was formerly Section 1146(c) pre-BAPCPA]
 - ▶ Section 1146(a) does not apply to sales of assets prior to confirmation of a plan, but only applies to transfers pursuant to a confirmed plan. See *Florida Dep’t of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33, 128 S. Ct. 2326, 171 L. Ed. 2d 2003 (2008).
 - ▶ Issue – concurrent sale of assets by a non-debtor. See *In Re T.H. Orlando Ltd.*, 391 F.3d 1287 (11th Cir. 2004) (non-debtor’s mortgage transaction was necessary to consummation of debtor’s plan and thus exempt from Florida’s stamp tax, even though both parties to the transaction were nondebtors and the transaction involved non-estate property).
 - ▶ It is essential to include Section 1146(a) exemption language in a Section 363 sale order. If possible, sale order should not take effect until plan is confirmed if there are significant transfer taxes.
 - ▶ What is a “stamp tax or similar tax”?
 - ▶ No definition of these taxes in the Bankruptcy Code
 - ▶ Black’s Law Dictionary 1259 (5th ed. 1979) defines “stamp tax” as the “[c]ost of stamps which are required to be affixed to legal documents such as deeds, certificates, and the like.” The definition also contains a cross-reference to “[d]ocumentary stamp,” which Black’s defines as “[s]tamp required by federal (prior to 1968) and state law to be affixed to deeds and other documents of transfer before they may be recorded, the cost of which is generally governed by the consideration recited in the document.” This definition indicates that there are at least two attributes to a stamp tax, as that term is commonly understood: the tax must be paid prior to recordation and the amount due is generally government by the consideration provided in the instrument.
 - ▶ Other courts have found the following “common elements” shared by all stamp or similar taxes: (1) they are imposed only at the time of transfer or sale of the item at issue; (2) the amount due is determined by the consideration for, par value of, or value of the item being transferred; (3) the tax rate is a relatively small percentage of the consideration, par value or value of the property; (4) the tax is imposed irrespective of whether the transferor enjoyed a gain or suffered a loss on the underlying sale or transfer; and (5) in the case of state documentary taxes, the tax must be paid as a prerequisite to recording.
 - ▶ Section 1146(a) clearly applies to sales of real estate in Florida, where documentary stamp taxes and intangible taxes are typically assessed on certain transfer documents and debt instruments

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Priorities of Tax Liens

- ▶ Priorities of tax liens
 - ▶ State and county liens - sales taxes, ad valorem property taxes
 - ▶ Nature and extent of IRS liens
 - ▶ When does the IRS get a lien, and what does it cover - 26 U.S.C. § 6321 (federal tax lien attaches to all property and *rights to property*, with “property” broadly defined to include every type of right or interest protected by law and having a negotiable value)
 - ▶ Where to check to see if filed and perfected. 26 USC § 6323(f), § 713.901(3), Florida Statutes (the place of filing is either the county or with Secretary of State)
 - ▶ IRS vs. Article 9 perfected secured creditor 26 U.S.C. § 6323
 - ▶ First in time, with 45-day Rules
 - ▶ Loan advances made within 45 days after filing of a tax lien notice - if perfected, made without notice of tax lien, and on then-existing property
- ▶ Lien on after-acquired property and identifiable proceeds, if acquired within 45 days, again, without notice to lender of tax lien. Does not cover “proceeds of proceeds.” Only applies to lenders acting in the ordinary course of their business

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Subchapter-S Status as Property of the Estate

- ▶ *Is a debtor's tax status as a pass-through entity under Subchapter S a property right of the debtor?*
 - ▶ *Majestic Star Casino LLC v. Barden Development Inc. (In re Majestic Star Casino LLC)*, 716 F.3d 736 (3d Cir. 2013) (affirming dismissal of proceeding to set aside as unauthorized post-petition transfer revocation of debtor's sub-S status, as status did not constitute an interest of the debtor in “property” in a bankruptcy case).
 - ▶ *Arrowsmith v. U.S. (In re Health Diagnostic Laboratory Inc.)*, 2017 WL 6061579, AP No. 17-04300 (Bankr. E.D. Va. Dec. 6, 2017) (S-corp status is not a debtor's property under Section 541 - dismissing fraudulent transfer claim seeking to avoid election made by parent to terminate debtor's S-corp status).
 - ▶ Other courts have held, before *Majestic Star*, that S-Corp status is a property right. [*Halverson v. Funaro \(In re Frank Funaro, Inc.\)*, 263 B.R. 892 \(B.A.P. 8th Cir. 2001\)](#); [*Parker v. Saunders \(In re Bakersfield Westar\)*, 226 B.R. 227 \(B.A.P. 9th Cir. 1998\)](#); [*Hanrahan v. Waltermann \(In re Waltermann Implement, Inc.\)*, No. 05-07284, 2006 WL 1562401 \(Bankr. N.D. Iowa May 22, 2006\)](#); [*Guinn v. Lines \(In re Trans-Line West, Inc.\)*, 203 B.R. 653 \(Bankr. E.D. Tenn. 1996\)](#).
- ▶ What planning opportunities do debtors or debtor-parents have, before or during a case, and what defenses to those opportunities might creditors have?

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Further Tax Considerations in Section 363 Sales

TAXABLE SALE OR TAX-FREE REORGANIZATION

- ▶ If a sale under Section 363 involves all or substantially all of the debtor's assets, the sale may be structured as either a taxable sale of assets or a tax-free reorganization (a "G" reorganization) under the Internal Revenue Code.
 - ▶ The four requirements for a "G" reorganization are:
 1. purchaser must be a corporation (or treated as a corporation for US federal tax purposes);
 2. debtor corporation must transfer all or substantially all of its assets to the purchaser;
 3. the purchaser must pay the debtor for its assets utilizing either the purchaser's stock or the purchaser's securities; and
 4. the debtor must distribute to its stockholders (which includes creditors) the stock or securities that it receives from the purchaser in timely liquidation of the debtor pursuant to the confirmed plan of reorganization
 - ▶ If any one of the above requirements is not met, the transaction will be treated as a taxable transaction.
 - ▶ In a "G" reorganization, (i) the debtor will not pay tax on the stock and securities received from the purchaser, (ii) the purchaser's tax basis will be the same as the debtor's tax basis in each asset, and (iii) the purchaser will acquire all of the debtor's tax attributes
- ▶ If the Section 363 sale is a taxable transaction, then:
 - ▶ The debtor will recognize a taxable gain if, on an asset by asset basis, the fair market value of the consideration received by the debtor from the purchaser is in excess of the debtor's adjusted tax basis in each asset
 - ▶ Taxable gain to the debtor can be offset by the debtor's tax attributes (e.g., net operating losses and certain credits) – the purchaser does not receive any of the debtor's tax attributes
 - ▶ The debtor will recognize a taxable loss if, on an asset by asset basis, the debtor's adjusted tax basis in each asset sold is greater than the consideration received for such asset
 - ▶ It is possible for a debtor to have both a taxable gain and a taxable loss with respect to the assets sold
- ▶ To the extent possible, a debtor wants to structure a transaction in a manner to avoid any tax liability – either through a taxable loss to the debtor in a transaction or the debtor being able to use its tax attributes and offset any taxable gain

Net Operating Losses (NOLs)

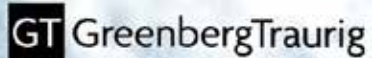
- ▶ Debtor's accrued pre-petition NOLs are property of its bankruptcy estate under Bankruptcy Code Section 541(a). *In re Taylor*, 386 B.R. 361, 368 (Bankr. S.D. Fla. 2008), aff'd sub nom. U.S. v. Kapila, 402 B.R. 56 (S.D. Fla. 2008).
- ▶ NOLs can be carried back to claim refunds of taxes paid in prior years
 - ▶ Generally, you must carry back the entire amount of the NOL to the 2 years before the NOL year
 - ▶ Can waive carryback period; but once you choose to waive it is generally irrevocable
- ▶ NOLs can be carried forward to offset income in future years
 - ▶ You can carry forward any remaining NOL up to 20 years
 - ▶ Carryforwards can also be used in a transaction implemented under a Chapter 11 plan
- ▶ Special rules apply to the use of NOLs in the case of equity ownership changes that occur in a bankruptcy case

Reduction of Tax Attributes

Generally, a debtor is not required to recognize income from the cancellation of debt in a bankruptcy case. However, certain tax attributes of the bankruptcy estate must be reduced by the amount of income that was previously excluded as a result of cancellation of debt during the bankruptcy proceeding. The order of reduction is generally—

- ▶ Net operating loss— reduce any NOL for the tax year in which the debt cancellation takes place, and any NOL carryover to that tax year.
- ▶ General business credit carryovers
- ▶ Minimum tax credit
- ▶ Capital losses—reduce any net capital loss for the tax year of the debt cancellation, and any capital loss carryover to that year.
- ▶ Basis—reduce the basis of the debtor's property, this reduction applies to the basis of both depreciable and nondepreciable property.
- ▶ Passive activity loss and credit carry-overs

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Sovereign Immunity

- Bars all lawsuits against the United States or its agencies in the absence of its consent as expressly manifested by Congress.
- Waivers strictly construed. *U.S. v. Kubrick*, 444 U.S. 111 (1979).
- Sovereign can only be sued in the manner in which it consents to be sued. *Stanley v. CIA*, 639 F.2d 1146 (5th Cir.1981) (Congress may provide the conditions under which an action can be maintained against the United States).
- A court lacks jurisdiction to entertain an action brought against the United States absent an express statutory waiver of sovereign immunity. *United States v. Dalm*, 494 U.S. 596 (1990).

Sovereign Immunity

- Section 106(a)(1) lists 59 provisions as to which immunity is abrogated, including:
 - Section 362 – automatic stay
 - Section 505 – determination of tax liabilities
 - Section 502 – allowance of claims
 - Section 510 – subordination

Resolution of Tax Claims

Objection to claim

- Be sure to serve properly.
 - Rules 7004(b)(4) and (5)
 - Service on IRS at Rule 5003(e) address
 - Service on U.S. Attorney – “Attention: Civil Process Clerk”
 - Service on Attorney General
- A proof of claim is prima facie valid and deemed allowed unless a party in interest objects.
 - Under the Supreme Court case of *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15 (2000), however, the taxpayer/debtor maintains the burden of proving its tax liability.

Resolution of Tax Claims (continued)

505 Motion to Determine Tax Liability

- Section 505(a) of the Bankruptcy Code authorizes (but does not require) the bankruptcy court to determine “any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid.”
- A Section 505(a) determination is brought by motion (not adversary proceeding).
 - Where a taxing authority has already filed a proof of claim, a Section 505(a) determination would be functionally equivalent – with respect to discovery, the burden of proof, and other procedural aspects – to an objection to claim.

Resolution of Tax Claims (continued)

Estimation under Section 502(c)(1)

- Bankruptcy Code Section 502(c)(1) **requires** a bankruptcy court to estimate any contingent or unliquidated claim, the fixing or liquidation of which, would unduly delay the administration of the case.
- In order to have the court estimate a claim, the debtor must first establish that fixing or liquidating the claim would unduly delay the administration of the case.
 - Administrative expense claims
 - Priority tax claims to be paid in accordance with Section 1129(a)(9)(C)

Resolution of Tax Claims (continued)

- A contingent claim is one dependent on a future event. *See In re Keenan*, 201 B.R. 263, 264 (Bankr. S.D. Cal. 1996) (“It is generally settled that ‘if all events giving rise to liability occurred prior to the filing of the bankruptcy petition’, the claim is not contingent”).
 - Claims for past tax periods would not be contingent
- An unliquidated claim is one that cannot be determined through mathematical computations or agreements of the parties. *In re Interco, Inc.*, 137 B.R. 993, 997 (Bankr. E.D. Mo. 1992) (“courts have consistently defined an unliquidated claim as one that is not subject to ‘ready determination and precision in computation of the amount due’ or ‘capable of ascertainment by reference to an agreement or by simple computation.’”).
 - If a tax return is still under examination and the tax has not yet been assessed, it may be unliquidated.

Resolution of Tax Claims (continued)

- Potential downsides to estimation:
 - Debtor may be required to waive discharge of the particular claim, such that if and when the claim is ultimately liquidated, liability may still be asserted against the debtor.
 - Section 502(j) of the Bankruptcy Code could provide the taxing authority an avenue to seek reconsideration of its claim at a later date.
 - Courts do not agree on the preclusive effects (i.e., collateral estoppel or res judicata) of estimation.
 - This uncertainty may actually work to the debtor’s advantage – the taxing authority may be sufficiently concerned about the preclusive effect of an estimation ruling on its claims that it will negotiate an agreed resolution of an estimation motion.

Section 505 Prompt Determination of Tax Liabilities

Post-Petition Tax Liabilities

- Income taxes for tax year ending after the petition date are administrative expense claims
 - Generally must be paid in the ordinary course, and must be paid in full on the effective date of a chapter 11 plan, “except to the extent the holder of a particular claim has agreed to a different treatment.”
- Audit Review Period
 - Generally, tax returns are subject to audit for three years.
 - Problematic for confirming a chapter 11 plan and closing out a bankruptcy case
 - Parties cannot wait three years to achieve finality.

Section 505 Prompt Determination of Tax Liabilities (continued)

- Need for a “prompt determination” of any tax liability of the estate.
- The Bankruptcy Code provides a special mechanism for debtors to shorten the otherwise applicable audit review period for post-petition tax returns (i.e., generally three years for non-fraudulent federal tax returns).
- Only available for post-petition tax liabilities “incurred during the administration of the case.”
- Consequences of Not Seeking Prompt Determination
 - Objections to confirmation based on, among other issues, feasibility.
 - Delay of a plan’s effective date and distributions to creditors.

Section 505 Prompt Determination of Tax Liabilities (continued)

Section 505(b)(2) Prompt Determination Procedures

- Bankruptcy Code Section 505(b)(2) allows a debtor to request that a taxing authority make a “prompt determination” of any tax liability incurred by the bankruptcy estate during the administration of the case.
 - Section 505(b)(2) applies to federal and state taxes.
- In order to avail itself of Section 505(b)(2), the debtor must:
 - prepare and file its tax returns,
 - pay any tax due as showing on such returns, and
 - then send copies of those returns to specific addresses designated by the taxing authorities for prompt determination requests and follow any other specific procedures promulgated by the taxing authorities (*see, e.g.*, IRS Rev. Proc. 2006-24).

Section 505 Prompt Determination of Tax Liabilities (continued)

- Taxing authorities have 60 days to notify the debtor whether it has selected the return for examination.
- If the taxing authority does not notify the debtor within 60 days, or notifies the debtor that the return is not being selected for examination, then, *unless the return is fraudulent or contains a material misrepresentation*, the debtor, the estate, trustee, and any successor to the debtor are discharged from any liability for such tax, upon payment of the tax shown on the return.

Section 505 Prompt Determination of Tax Liabilities (continued)

- If the taxing authority notifies the debtor within 60 days that the return has been selected for examination, then the taxing authority has 180 days from the date the prompt determination request was made to complete the examination.
 - This deadline can be extended by the Bankruptcy Court for “cause.”

Section 505 Prompt Determination of Tax Liabilities (continued)

- If, after examination, the taxing authority determines that additional tax is due, then upon payment of such tax, unless the return is fraudulent or contains a material misrepresentation, the debtor, the estate, trustee, and any successor to the debtor are discharged from any liability for such tax.
- Alternatively, if, after the examination, the debtor disputes the taxing authority’s determination, then the bankruptcy court can determine the tax after “notice and a hearing.”
 - Upon payment of the tax as determined by the bankruptcy court, unless the return is fraudulent or contains a material misrepresentation, the debtor, the estate, trustee, and any successor to the debtor are discharged from any liability for such tax.

Section 505 Prompt Determination of Tax Liabilities (continued)

Section 505(a)(2)(B) Refund Claims

- Bankruptcy Code Section 505(a)(1) grants jurisdiction to bankruptcy courts to adjudicate certain tax disputes, and states:
 - “Except as provided in paragraph (2) of this subsection, the court may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction.”

Section 505 Prompt Determination of Tax Liabilities (continued)

- One of the exceptions in paragraph (2) of the statute relates to tax refunds, and states that the bankruptcy court may not:
 - “determine . . . any right of the estate to a tax refund, before the earlier of —
120 days after *the trustee* properly requests such refund from the governmental unit from which such refund is claimed; or
a determination by such governmental unit of such request.”

Section 505 Prompt Determination of Tax Liabilities (continued)

- A bankruptcy court lacks subject matter jurisdiction to determine a tax refund claim under Section 505(a)(2)(B) of the Bankruptcy Code where the refund was requested by a liquidating trustee appointed pursuant to a plan, as opposed to a pre-confirmation bankruptcy trustee or debtor-in-possession. *United States v. Bond*, 762 F.3d 255 (2nd Cir. 2014).
 - Neither a bankruptcy trustee nor a debtor-in-possession (which has the powers of a trustee under Section 1107 of the Bankruptcy Code) requested the refund
 - Instead the refund was requested by the liquidating trustee appointed pursuant to the plan

Section 505 Prompt Determination of Tax Liabilities (continued)

- The Second Circuit held that the statutory prerequisite to bankruptcy court jurisdiction under Section 505(b)(2)(B)(i) had not been satisfied, and the bankruptcy court lacked subject matter jurisdiction to determine the refund claim.
 - Distinguished trustees and debtors-in-possession on the one hand, whose powers are established by Congress and set forth in the Bankruptcy Code, from liquidating trustees on the other, whose powers are established under a plan and liquidating trust agreement.
 - Strictly construed the statute and held that a liquidating trustee appointed pursuant to Section 1123(b)(3)(B) is not a “trustee” under Section 505(a)(2)(B)(i)
 - Therefore the bankruptcy court lacked jurisdiction to determine the refund claim because the refund claim was not requested by “the trustee.”

Section 505 Prompt Determination of Tax Liabilities (continued)

- The Second Circuit did not reject the notion that, under Section 1123(b)(3)(B), the tax refund claim could be assigned to the liquidating trust and pursued by the liquidating trustee.
 - Held only that because the liquidating trustee – as opposed to a pre-confirmation bankruptcy trustee or debtor-in-possession – had requested the refund, the statutory prerequisite for bankruptcy court jurisdiction over a tax refund claim under Section 505(b)(2)(B) of the Bankruptcy Code had not been satisfied, and that the bankruptcy court therefore lacked subject matter jurisdiction to determine the refund claim.

Section 505 Prompt Determination of Tax Liabilities (continued)

- Chapter 11 debtors-in-possession with potential tax refund claims should properly request refunds *before* confirmation of a plan, if they want to preserve the ability to ultimately have the bankruptcy court determine the refund claim (even if later transferred to a liquidating trust and pursued by a liquidating trustee).
 - Absent satisfaction of this statutory prerequisite, a post-confirmation liquidating trustee can still pursue a refund claim, but would have to bring that claim in District Court or the Court of Federal Claims pursuant to applicable tax law and within the applicable statute of limitations.

42nd Annual Alexander L. Paskay Memorial Bankruptcy Seminar
Clash of the Codes: Bankruptcy Tax Issues Made Simple

Bankruptcy Tax and the Individual Debtor

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I. INTRODUCTION

“Taxes,” as Justice Holmes informed us long ago, “are what we pay for civilized society.”¹ It may surprise many that this price is extracted even from individuals in bankruptcy. Although the right to discharge in bankruptcy ensures an “honest but unfortunate debtor” a fresh start to begin anew his or her economic life, that right is tempered by the government’s legitimate interest in protecting the public fisc by collecting taxes. The balance struck by the Bankruptcy Code² and Internal Revenue Code³ between the competing interests of an individual debtor and the federal government insulates specific tax claims from the bankruptcy discharge. Under this compromise, only enumerated tax claims will survive a bankruptcy discharge in an individual debtor’s bankruptcy 11 case.⁴

Recognizing that nondischargeable tax liabilities are inconsistent with the fresh start policy, Congress further attempted to alleviate some harshness through enactment of the Bankruptcy Tax Act of 1980 (“BTA”).⁵ Among other things, the BTA creates a separate taxable entity where an individual files for relief under either chapter 7 or 11 of the BC⁶ and enables an individual chapter 7 or 11 debtor to elect to shorten and end the taxable year, thus shifting at least part of the current year taxes to the estate as a BC section 507(a)(8) priority claim.⁷ Nevertheless, certain tax claims designated as nondischargeable under BC section 523(a)(1) (such as claims for

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

² 11 U.S.C. § 101 *et seq.* In these materials, the Bankruptcy Code is also referred to as “BC.”

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

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

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

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

⁷ See IRC § 1398(d)(2).

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

The outline begins with a discussion of the rules regarding the treatment of cancellation of indebtedness ("COD") income both in and out of financial distress. A careful assessment of the application, limitations, and exclusions of IRC section 108 are explored with examples delineating key concepts and missteps in areas of insolvency, bankruptcy, and qualified principal residence indebtedness. The outline then turns to a discussion of the tax issues generated by mortgage modifications and foreclosures, a common occurrence with individual taxpayers who happen to own homes either as their primary residence or as an investment or second home. Additionally, the outline focuses on the separate entity rules for individuals who file for relief under chapter 7 or 11 of the BC. Finally, the outline considers the rules regarding the priority and dischargeability of tax claims, carefully distinguishing between the tax relief a debtor could expect in a chapter 7 or 11 case as opposed to a chapter 13 case. Each nondischargeable tax claim will be addressed with particular attention to the recurring issues that one confronts in an individual debtor bankruptcy practice. The materials will conclude with several practice pointers that blend both substantive bankruptcy tax law with bankruptcy procedure.

The materials will introduce the reader to nine principles that every bankruptcy practitioner must know. These nine principles are:

1. Identifying the tax claim. The taxing authority may have a claim based on gain and/or COD income, for example, where property owned by the taxpayer is foreclosed on and any deficiency released by the creditor. Generally, gross income includes gain from property and COD. IRC section 61(a).
2. Identifying the taxpayer. For taxes, the debtor is the taxpayer except where IRC section 1398 applies and changes the general rule.
3. Not all taxes are nondischargeable.⁸

⁸ See IRC § 523(a).

4. Secured tax claims – even those securing nondischargeable tax claims – are recognized in bankruptcy and largely protected from various avoidance powers attacks.
5. Looking back from the petition date, what returns were last due (including extensions) within the last three years? Personal taxes are dischargeable if the tax year in question is more than three years prior to the filing of the bankruptcy case unless some other provision applies.
6. Have any taxes been assessed within 240 days preceding the petition date? Personal taxes are dischargeable if the tax in question has been assessed more than 240 days prior to the filing of the bankruptcy case unless some other provision applies.
7. Are any returns still under audit or at audit risk (not including those that involve fraudulent returns, etc.), before the tax court, or under open assessment? Claims associated with such returns are both priority and nondischargeable.
8. Are there any late filed returns or years in which no return was filed? Personal taxes are dischargeable if the tax return for the year in question was filed at least more than two years prior to the bankruptcy filing.
9. Are there any taxes that arise from the filing of fraudulent returns or willful attempts to evade or defeat a tax (with no time limit)?

II. COD SCENARIOS

Federal tax issues often arise in the course of contemplating a variety of responses to too much debt. For example, the release of credit card debt by a credit card company, the write down of indebtedness often to the fair market value of any collateral like a home mortgage, and the transfer of property in complete or partial satisfaction of indebtedness are all potential triggering tax events that may generate COD income or gain (or loss).

A. RELEASE OF DEBT

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

B. WRITE DOWN OF RECOURSE AND NONRECOURSE INDEBTEDNESS

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

C. TRANSFER OF PROPERTY IN SATISFACTION OF INDEBTEDNESS

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

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

III. COD INCOME METHODOLOGY

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

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

The *first order* inquiries involve the following:

1. ***Has an event taken place that could potentially give rise to COD income or gain?*** Here, one would determine whether there has been a write down of indebtedness, partial or complete forgiveness of debt, a material modification of the indebtedness, a direct or indirect acquisition of debt by a related party, a transfer of property in satisfaction of debt, or some other sale or exchange.
2. ***Is there either a case law or statutory rule of nonrealization that may apply?*** Here, the case law and statutory rules of exception include the gifts exception, the indebtedness subject to bona fide dispute exception, lost deduction exception, purchase price adjustment exception, contribution of capital exception, stock-for-debt exception, and partnership equity-for-debt exception.
3. ***When, if at all, must the COD income or gain be realized?*** Here, the rules on when COD income occurs are muddled. Under state law, one should generally look to some objective act that evidences a partial or complete discharge, material modification, etc., of indebtedness. If the discharge allegedly occurs in bankruptcy, one must isolate a bankruptcy court order discharging the indebtedness.

The *second order* inquiry includes:

Assuming a taxpayer must realize COD income, is there a rule of nonrecognition that may apply? The rules of nonrecognition embodied in IRC §108 that are generally relevant to restructurings include the (i) bankruptcy exception; (ii) insolvency exception; (iii) qualified farm indebtedness exception; (iv) qualified real property indebtedness exception; and (v) qualified principal residence indebtedness

forgiveness occurring between January 1, 2007, to January 1, 2015 (tax years 2007-2014) .

The *third order* inquiry includes:

Assuming either the insolvency or bankruptcy rule of nonrecognition applies, should you reduce tax attributes as identified in section 108(b) or elect to reduce basis in depreciable assets or employ a strategy that uses a combination of the two approaches? Here, one must decide whether a taxpayer receives a greater benefit by electing to reduce basis in depreciable property or by simply reducing tax attributes in accordance with IRC §108(b), or embrace an approach that uses a combination of the two alternatives in an effort to minimize potential tax liabilities while preserving tax attributes. For those situations where the qualified principal residence indebtedness rule applies, the taxpayer must reduce the basis in his principal residence (if the taxpayer still owns the main home) by the amount not recognized but to no less than zero.⁹

The *fourth order* inquiries include:

1. *Has the filing of a petition in bankruptcy changed the taxpayer, that is, changed who is liable for the tax?* Here, one must determine whether the separate entity rules under IRC §1398 apply. If so, the bankruptcy estate is a separate taxpayer, with the duty to report, account for, and pay any tax due.
2. *Assuming that IRC §1398 does apply, should you make the section 1398(d)(2) election?* The election allows a debtor to bifurcate the tax year, often to the benefit of a debtor by converting what would otherwise be a nondischargeable postpetition obligation into a prepetition priority claim against the estate.

⁹ IRS Publication 4681 (2015), *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*. An individual taxpayer would enter the amount of the basis reduction on line 10b of IRS Form 982. For details regarding basis of a main home, see IRS Publication 523 (2015).

IV. OVERVIEW OF COD INCOME

The savings realized by a taxpayer from the material modification, reduction, or total discharge of a bona fide debt may be income for tax purposes.¹⁰ The Supreme Court established this principle in *United States v. Kirby Lumber Co.*¹¹ In *Kirby*, the corporate taxpayer purchased its own bonds at a discount on the open market. The Court held that the taxpayer realized income to the extent the issue price for the bonds exceeded the price paid for the reacquisition of those bonds.¹² Section 61(a)(12) of the IRC provides that gross income includes “income from the discharge of indebtedness.”¹³ While neither the IRC nor Treasury regulations provide any further definition of what constitutes COD income, case law has provided that COD income may result from complete or partial forgiveness of indebtedness,¹⁴ the modification of the terms of indebtedness,¹⁵ or the foreclosure of property subject to recourse debt.¹⁶ Generally, upon

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

¹¹ 284 U.S. 1 (1931).

¹² *Id.* at 3. The Supreme Court explained:

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

¹³ IRC § 61(a)(12).

¹⁴ See *Commissioner v. Jacobson*, 336 U.S. 28, 38-40 & n.7 (1949) (holding repurchase of secured bonds at prices below that at which they were sold generated gain attributable to taxpayer's income).

¹⁵ See *Stackhouse v. United States*, 441 F.2d 465, 469 (5th Cir. 1971) (stating modification of partnership's debt is considered a pro rata distribution of money to each partner, creating income to partners individually). *But see* IRC § 108(e)(5). Under § 108(e)(5), the modification of a purchase-money debt will not produce income where the reduction does not occur in a title 11 case or when the taxpayer is insolvent. *Id.*

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

discharge of indebtedness, a taxpayer realizes income in an amount equal to the difference between the amount due on the obligation and the amount paid for the obligation's discharge.¹⁷

Example 4: Debtor borrows \$500 from Lender, to be repaid one year from the loan. Lender subsequently cancels the debt after unsuccessfully attempting to recover. The original transaction would have no tax significance since the loan benefits to Debtor would be offset by the obligation to repay. If the obligation is removed, Debtor theoretically benefits from the “freeing up” of assets. This “benefit” is taxable. A more elegant way in which to view the situation is through the lens of the tax benefit rule.¹⁸ In Year 1, the loan had no tax significance because the accession in wealth was tempered by a corresponding liability. Thus, the transaction is a “tax wash.” However, in Year 1+X, an event takes place that makes the manner in which you treated the original transaction in Year 1 no longer valid. The event, of course, is the forgiveness of the indebtedness. Thus, the tax benefit rule requires that the taxpayer make the necessary adjustments in Year 1+X to reflect the realities of the present situation.

Before enactment of the BTA,¹⁹ the general rule was that debt discharge resulted in the realization of income to the extent of the amount discharged.²⁰ However, exceptions to this general rule evolved through case law, including the (1) gift exception, (2) bona fide debt exception, (3) stock-for-debt exception,²¹ (4) contribution of capital exception,²² and (4) purchase price adjustment exception.²³ Furthermore, debt forgiven in a bankruptcy proceeding and debtors who were insolvent both before and after the debt forgiveness also qualified for a limited exception to the general rule requiring the realization of COD income.²⁴ Finally, corporations and certain

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

¹⁸ See Alice Cunningham, *Payment of Debt with Property--The Two Step Analysis After Commissioner v. Tufts*, 38 TAX LAW. 575, 599-605 (1985).

¹⁹ Pub. L. No. 96-589, 94 Stat. 3389.

²⁰ See IRC § 61(a)(12). An in-depth treatment of the prior law governing discharge of indebtedness appears in C. RICHARD MCQUEEN & JACK F. WILLIAMS, *FEDERAL TAX CONSEQUENCES OF BANKRUPTCY LAW AND PRACTICE* §23.01 (3d ed. 1997).

²¹ MCQUEEN & WILLIAMS, *supra*, § 21.16.

²² *Id.* § 21.15.

²³ *Id.* § 21.14.

²⁴ Treas. Reg. § 1.61-12(b)(1) (as amended in 1980). See *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95, 96 (5th Cir. 1934) (finding no income where cancellation of past due debt does not have effect of increasing asset's value); *F.W. Sickles Co. v. United States*, 31 F. Supp. 654, 656 (Ct. Cl. 1940) (noting

non-corporate taxpayers, to the extent solvent after debt forgiveness, could avoid income recognition by making an election under IRC section 108 and consenting to a reduction of basis in assets, depreciable and non-depreciable, under IRC section 1017.²⁵

A number of problems existed under prior law regarding treatment of COD income. For instance, a debtor who elected to avoid recognizing COD income by reducing basis in property under IRC section 1017, could effectively convert what otherwise would have been ordinary income into capital gain upon selling those assets with a reduced basis. In some instances, certain nondepreciable assets, such as land or stock of a subsidiary corporation, might never be sold in the normal course of business. This resulted in the total avoidance of a tax liability, rather than mere deferral of the tax.²⁶

A. COD INCOME UNDER IRC SECTION 108

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

- (1) the discharge occurs in a title 11 case;²⁷
- (2) the debtor is insolvent immediately before the discharge;²⁸
- (3) the indebtedness is considered "qualified farm indebtedness;"²⁹

insolvent taxpayer has no income generated from discharge of indebtedness).

²⁵ See McQUEEN & WILLIAMS, *supra*, § 23.11.

²⁶ H.R. REP. NO. 833, 96th Cong., 2d Sess. 9 (1980); S. REP. NO. 1035, 96th Cong., 2d Sess. 9-10 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7025 (noting possibility that taxpayer might take reduction in basis in property which would never be sold).

²⁷ IRC §108(a)(1)(A). Thus, it is imperative that any COD occur pursuant to a court order or confirmed plan. Michael G. Frankel, *Tax Planning for Troubled Real Estate and Partnership Transactions-Part I*, 19 J. REAL EST. TAX'N 285, 290 (1992). The BTA defines a title 11 case as a federal bankruptcy case brought under title 11. *See* IRC §108(d)(2). In addition, the taxpayer must be under the court's jurisdiction, and the discharge must be either granted by the court or pursuant to a court-approved plan.

²⁸ IRC § 108(a)(1)(B). The Bankruptcy Tax Act of 1980 states that other than those exceptions specifically provided in IRC § 108(e), there is no other insolvency exception to the rule that gross income includes debt discharge income. *Id.* § 108(e)(1).

²⁹ *Id.* § 108(a)(1)(C).

- (4) the indebtedness is considered “qualified real property indebtedness,”³⁰ or
- (5) the indebtedness is considered qualified principal residence indebtedness that is discharged before January 1, 2015.³¹

Furthermore, title 11 debtors, insolvent taxpayers, and taxpayers with qualified farm indebtedness are given a choice of tax consequences to provide broader flexibility and a more robust fresh start. In accordance with IRC § 108 and 1017, taxpayers may apply the amount of COD income against certain statutorily delineated tax attributes, such as net operating losses and carryovers,³² or elect to apply any portion of COD to reduce the basis of “depreciable property” or a combination of both.³³ This choice allows taxpayers the flexibility of accounting for COD income in a manner most favorable to their own tax positions.³⁴

B. COD ISSUES UNRESOLVED BY IRC SECTION 108

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

- (1) *Has an event triggering cancellation of indebtedness income occurred?*

³⁰ *Id.* § 108(a)(1)(D). The insolvency exclusion takes precedence over the qualified farm or real property indebtedness exclusions (but not the qualified principal residence exclusion unless a taxpayer elects otherwise), and the title 11 bankruptcy exclusion takes precedence over all others. *Id.* § 108(a)(2).

³¹ *Id.* § 108(a)(1)(E) and (h).

³² *Id.* § 108(b). Provision is made for the potential reduction of certain tax attributes and the order in which they may be reduced is set out. *Id.* § 108(b)(2)(A)-(G).

³³ *Id.* § 108(b)(5).

³⁴ For example, it would be advantageous for a taxpayer to reduce net operating losses where it believes that they will end up being “wasted” due to lack of income. S REP. NO. 1035, reprinted in 1980 U.S.C.C.A.N. at 7025. However, where a taxpayer expects to have income which could be offset by net operating losses, the taxpayer may also reduce basis in property. *Id.*

Section 108 fails to provide a working definition of the term *discharge of indebtedness*. Consequently, courts will continue to bear the responsibility of developing a definition through the interstitial growth of case law.³⁵ The American Bar Association Section of Taxation has proposed a good working model of discharge of indebtedness. In the Report of the Section 108 Real Estate and Partnership Task Force,³⁶ the Section suggests as a starting point the following two-part test: (1) whether at the inception of the loan transaction, the borrowed funds were excluded from the taxpayer's income upon receipt because of the offsetting obligation to repay; and (2) if so, whether the taxpayer's obligation to repay has been canceled, forgiven, or reduced.³⁷ Nonetheless, a taxpayer might argue that section 108 is not applicable, by citing a judicial exception to the general rule of COD income. For example, under prior case law no COD income was realized when the cancellation of a debt was intended as a gift³⁸ or the cancellation was of a disputed debt.³⁹ The failure of IRC section 108 to provide a precise definition of *discharge of indebtedness* should not affect this conclusion.

The IRC describes *indebtedness of the taxpayer* as inclusive of two distinct types of indebtedness: (1) debts for which a taxpayer is personally liable; and (2) debts on property owned

³⁵ See *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931) (repurchase of corporate bonds by corporation for less than par value constitutes discharge of indebtedness); *Commissioner v. Sherman*, 135 F.2d 68, 70 (6th Cir. 1948) (no gain in income where mortgage bank accepted partial payment and where effect of transaction was a reduction in purchase price of property); *Colonial Savings Ass'n. v. Commissioner*, 85 T.C. 855, 861 (1985), *cert. denied*, 489 U.S. 1090 (1989) (penalties for premature withdrawal of savings certificates do not give rise to income from discharge of indebtedness); *Edmont Hotel Co. v. Commissioner*, 10 T.C. 260, 263 (1948) (taxable income realized in acquiring own bonds at less than face value).

³⁶ American Bar Association Section of Taxation, *Report of the Section 108 Real Estate and Partnership Task Force, Part I*, 46 TAX LAW. 209 (1992) [hereinafter *ABA Report Part I*]; American Bar Association Section of Taxation, *Report of the Section 108 Real Estate and Partnership Task Force, Part II*, 46 TAX LAW. 397 (1993) [hereinafter *ABA Report Part II*].

³⁷ *ABA Report Part I, supra*, at 224.

³⁸ Tatlock, *supra*, at A-14.

³⁹ McQUEEN & WILLIAMS, *supra*, § 20.18.

by a taxpayer, such as a mortgage on real estate owned by the taxpayer.⁴⁰ Thus, discharges of both recourse and nonrecourse debts of a taxpayer are subject to section 108.⁴¹

Example 5: Taxpayer owes a \$1.5 million recourse debt, secured by an office complex valued at \$1.0 million. If Lender agrees to write down the debt as part of a restructuring to the fair market value of the collateral, Taxpayer will realize COD income of \$500,000.

Example 6: Same facts as above except that the indebtedness is nonrecourse. Taxpayer will realize COD income of \$500,000.⁴²

(2) *When was the cancellation of indebtedness income realized?*

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

As a general rule, a debt is discharged upon the earlier to occur of: (1) forgiveness by agreement of the parties; (2) cancellation by a binding act of the creditor or by operation of applicable law (such as in certain cases the running of the statute of limitations); or (3) a creditor's acceptance of payment of an amount less than the issue price of the debt (less any principal amounts previously repaid) in complete satisfaction thereof.⁴³

In bankruptcy, the timing of the event of discharge is even more muddled. The ABA would tie discharge of indebtedness to bankruptcy discharge under sections 727, 1141(d) or 1328.⁴⁴ However, where a creditor "enters into a binding agreement (generally pursuant to court order)" to forgive all or part of a debt before the discharge event, then COD income is realized at that point.⁴⁵ This is a sensible approach. Assuming the debt is dischargeable, the entry of a discharge

⁴⁰ IRC §108(d)(1).

⁴¹ See Rev. Rul. 91-31, 1991-1 C.B. 19. "The reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt ... results in the realization of discharge of indebtedness income" *Id.* at 20. See generally Tatlock, *supra*, at A-13 to A-14.

⁴² See Rev. Rul. 91-31.

⁴³ ABA Report Part I, *supra*, at 228.

⁴⁴ *Id.*

⁴⁵ *Id.* at 228-29.

order is the latest possible moment for the realization of COD income. Likewise, because of the requirement that a compromise or settlement involving the debtor or estate must be approved,⁴⁶ the court order approving the settlement is also a sensible point for realizing COD income. Since no discharge results from Chapter 7 cases involving partnerships or corporations or liquidations under Chapter 11, similar indicators, such as a final settlement of the affairs of the debtor entity should be used to determine when COD income occurs in such cases.⁴⁷

C. BANKRUPTCY EXCEPTION TO THE RECOGNITION OF COD INCOME

As previously discussed, a taxpayer need not recognize COD income if the discharge of debt occurs in a title 11 case.⁴⁸ Specifically, a taxpayer must be under the bankruptcy jurisdiction of a court at the time the COD occurs. Additionally, the debt discharge must occur pursuant to court order or a plan approved by the court.⁴⁹ Thus, it is important to ensure that a bankruptcy court order or a confirmation order approving a plan of reorganization specifically reference the discharge of indebtedness.⁵⁰

Assuming the bankruptcy exception in IRC §108(a)(1)(A) applies, the method of deferment is similar to that for the insolvency exception. A taxpayer must (1) reduce tax attributes in the order delineated in 108(b), (2) elect to reduce basis in depreciable property pursuant to section 108(b)(5), or (3) employ a combination of the two approaches. However, unlike the insolvency exception, the bankruptcy exception is not limited to the extent a taxpayer is insolvent.

⁴⁶ BANKR. R. 9019.

⁴⁷ See generally, Tatlock, *supra*, at A-12(1) to (2) (noting that COD income is realized when it is clear that debt will not be paid).

⁴⁸ IRC § 108(a)(1)(A).

⁴⁹ IRC § 108(d)(2).

⁵⁰ See Stern, *supra*, at A-8(1).

Thus, close calls on insolvency generally lead one to seek the relative comfort of certainty that bankruptcy provides for taxpayers with large amounts of potential COD income.

In sum, title 11 debtors and insolvent taxpayers are given a choice of tax consequences to provide broader flexibility and a more robust fresh start. In accordance with IRC sections 108 and 1017, taxpayers may apply the amount of COD income against certain statutorily delineated tax attributes, such as net operating losses and carryovers,⁵¹ or elect to apply any portion of COD to reduce the basis of “depreciable property” or a combination of both.⁵² This choice allows debtors the flexibility of accounting for COD income in a manner most favorable to their own tax positions.⁵³ However, to prevent the conversion of ordinary income associated with COD income into capital gain through an election to reduce basis, the BTA also provides that gains realized from the sale of assets with a reduced basis are subject to recapture of the amount of COD income as ordinary income and not as a capital gain.⁵⁴

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

⁵¹ *Id.* § 108(b). Provision is made for the potential reduction of the enumerated tax attributes and the order in which they may be reduced is set out. *Id.* § 108(b)(2)(A)-(G).

⁵² *Id.* § 108(b)(5).

⁵³ H.R. REP. No. 833, *supra*, at 8-9; S. REP. No. 1035, *supra*, at 9-10, *reprinted in* 1980 U.S.C.C.A.N. at 7025. For example, it would be advantageous for a taxpayer to reduce net operating losses where he believes that they will end up being “wasted” due to lack of income. S. REP. NO. 1035, *supra*, at 10, *reprinted in* 1980 U.S.C.C.A.N. at 7025. However, where a taxpayer expects to have income which could be offset by net operating losses, the taxpayer may also reduce basis in property. *Id.*

⁵⁴ IRC § 1017(d)(1). Subsequent dispositions of property whose basis has been reduced under § 1017 will give rise to income at ordinary rates under §§ 1245, 1250. *Id.*

D. INSOLVENCY EXCEPTION TO RECOGNITION OF COD INCOME

As previously discussed, a taxpayer need not recognize COD income to the extent the taxpayer is insolvent immediately before the discharge. However, another significant omission in section 108 is its failure to provide a meaningful definition of *insolvency*. Section 108 provides that a taxpayer is insolvent to the extent that its liabilities exceed the “fair market value” of its assets immediately before the debt discharge.⁵⁵ The IRC does not define “fair market value.”⁵⁶ The IRC’s traditional definition is the price at which property exchanges hands between a willing seller and a willing buyer, neither under a compulsion to act.⁵⁷ One commentator suggests that transaction costs associated with the disposition of the assets should be netted out before the calculation is made.⁵⁸ Although this approach is sensible, section 108 does not appear to support it.

Additionally, section 108 fails to consider specifically whether exempt assets should be included in the determination of insolvency.⁵⁹ Although opposed at one point, the IRS accepted this position on the exclusion of exempt assets, but has since recanted.⁶⁰ However, pre-BTA authority does exist for the exclusion of assets that are not subject to the claims of creditors under

⁵⁵ IRC §108(d)(3).

⁵⁶ Under Bankruptcy Code § 101(31), the valuation standard is “a fair value” and not “a fair market value.”

⁵⁷ Treas. Reg. § 1.70A-1(c)(2) (as amended in 1990) (concerning charitable contributions); *Id.* § 20.2031-1(b) (as amended in 1965) (discussing valuation of property in gross testamentary estates); *id.* § 25.2512-1 (as amended in 1992) (regarding valuation of property); *see also* IRS Rev. Rul. 59-60.

⁵⁸ Robert C. Livsey, *Determining if a Taxpayer is Insolvent for Purposes of the COD Income Exclusion*, 76 J. TAX’N 224, 224 (1992).

⁵⁹ Prior to enactment of the BTA, cases held that exempt assets were not counted for insolvency purposes. *See, e.g., Cole v. Commissioner*, 42 B.T.A. 1110, 1113 (1940) (holding that equity in insurance policies is not included as asset for insolvency determination).

⁶⁰ Priv. Ltr. Rul. 91-25-010 (Mar. 19, 1991). The Ruling noted that when considering whether or not a person is insolvent, only assets that are subject to claims of taxpayer’s creditors should be used to determine insolvency. *Id.* “[A] taxpayer’s entitlement to the insolvency exclusion... is based on all of the assets reachable by the individual taxpayer’s creditors.” Priv. Ltr. Rul. 89-20-019 (Feb. 14, 1989).

local law.⁶¹ Under this approach, from a creditor's perspective, insolvency should generally be calculated by reference to those assets that are ultimately available to a taxpayer's general creditors under state law to reduce their debts. The present IRS position is that exempt assets are included in the insolvency calculation.⁶² Recent authorities, moreover, hold that the word "assets" in section 108(d)(3) includes assets exempt from the claims of creditors under state law.⁶³

The determination of a taxpayer's insolvency is made "on the basis of the taxpayer's assets and liabilities immediately before the discharge."⁶⁴ Thus, where agreement is reached as to the terms of settlement of the claims, the date of actual settlement and not the date of the agreement is used for the insolvency determination.⁶⁵ Precisely when this event occurs is not always self-evident.

All of these shortcomings under the insolvency exception make the use of section 108 problematic. If one miscalculates the extent of insolvency at the time of debt discharge, there are no second chances. To the extent a taxpayer is solvent, it must recognize COD income and cannot use the tax attribute reduction rules in section 108 unless another exception applies. Consequently,

⁶¹ See, e.g., *Cole v. Commissioner*, 42 B.T.A. 1110, 1113 (1940) (holding that equity in insurance policies is not included as asset for insolvency determination); see also *Davis v. Commissioner*, 69 T.C. 814, 833-34 (1978). The court in *Cole* explained that under New York law the equity in the insurance policies of the taxpayer were free from claims of creditors. 42 B.T.A. at 1113. The court then determined that such exempt property should not be considered when determining insolvency. *Id.* at 1113.

⁶² TAM 199935002, revoking PLR 9130005.

⁶³ *Carlson v. Commissioner*, 116 TC 87 (2001). Gregory Stern poses an intriguing question. If property is excluded from the insolvency calculation, then is it also excluded from basis reduction under §§ 108 and 1017? Stern, *supra*, at A-7. I agree with Stern's answer that exclusion from basis reduction would be consistent with the rules applicable to the bankruptcy exclusion, where the debtor's property is protected from sale under the Bankruptcy Code and not included in the bankruptcy estate is not subject to basis reduction. *Id.* (citing IRC §1017(c)(1)). See also *Schieber v. Commissioner*, TC Memo 2017-32 (Feb. 9, 2017) (a taxpayer's interest in his employer's defined benefit pension plan under which he was entitled only to receive monthly payments is not an "asset" for purposes of determining insolvency).

⁶⁴ IRC § 108(d)(3). Note that the IRS treats preferred stock similar to a liability in making the insolvency computations. Treas. Reg. § 1.1502-19(a)(2)(ii) (as amended in 1991). I believe that preferred stock should be treated as equity and not as a liability for purposes of these discharge of indebtedness provisions.

⁶⁵ *Walker v. Commissioner*, 88 F.2d 170, 171 (5th Cir.), *cert. denied*, 302 U.S. 692 (1937).

risk averse folk, like most practitioners, opt for the certainty of bankruptcy, thus increasing bankruptcy filings.

V. NONREALIZATION OF COD INCOME

The BTA substantially modified prior law governing federal income tax treatment of COD income. Congress intended that the BTA effectuate sound bankruptcy and tax policy by setting forth clear rules governing transactions occurring both inside and outside of bankruptcy.⁶⁶ Congress also intended to remedy some of the problems arising under prior law, while simultaneously affording taxpayers a degree of flexibility not previously available to them.⁶⁷ Accordingly, the BTA and its amendments changed section 108 to provide that a taxpayer's gross income shall not include amounts realized from the discharge of indebtedness when: (1) the discharge occurs in a title 11 case;⁶⁸ (2) the debtor is insolvent immediately before the discharge;⁶⁹ (3) the indebtedness is considered "qualified farm indebtedness;"⁷⁰ (4) the indebtedness is considered "qualified real property indebtedness;"⁷¹ or the indebtedness is considered qualified

⁶⁶ H.R. REP. NO. 833, *supra*, at 8; S. REP. No. 1035, *supra*, at 9-10, *reprinted in* 1980 U.S.C.C.A.N. at 7024-7025.

⁶⁷ H.R. REP. NO. 833, *supra*, at 9; S. REP. No. 1035, *supra*, at 10, *reprinted in* 1980 U.S.C.C.A.N. at 7025.

⁶⁸ IRC § 108(a)(1)(A). Thus, it is imperative that any COD occur pursuant to a court order or confirmed plan. Frankel, *supra*, at 290. The BTA defines a title 11 case as a federal bankruptcy case brought under title 11. IRC § 108(d)(2). In addition, the taxpayer must be under the court's jurisdiction, and the discharge must be either granted by the court or pursuant to a court-approved plan. *Id.* The election by a solvent debtor to apply COD income against tax attributes in order to defer the tax consequences, rather than the basis of depreciable assets, is limited to situations where the debt discharge occurs in a title 11 case. This is peculiar considering that the preferential treatment accorded a "G reorganization" is available in a "title 11 or similar case," *id.* § 368(a)(1)(G), which includes receiverships, foreclosures, and similar proceedings, whether in federal or state court, *id.* § 368(a)(3)(A), as well as certain federal or state agency receivership proceedings involving financial institutions, § 368(a)(3)(D). The House and Senate Committee Reports to the BTA do not describe the rationale behind this disparity, and at least one commentator on the subject asserts there is no justification for it despite a similar difference in treatment under prior law.

⁶⁹ IRC § 108(a)(1)(B). The BTA states that other than those exceptions specifically provided in IRC § 108(e), there is no other insolvency exception to the rule that gross income includes debt discharge income. *Id.* § 108(e)(1). IRC § 108 also provides special rules relating to the treatment of COD income by partnerships and Subchapter S corporations. *Id.* § 108(d)(6)-(7).

⁷⁰ *Id.* § 108(a)(1)(C). Indebtedness qualifies as "qualified farm indebtedness" if:

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

Id. § 108(g)(2)(A)-(B).

⁷¹ *Id.* § 108(a)(1)(D). The insolvency exclusion takes precedence over the qualified farm or real property indebtedness exclusions, and the title 11 bankruptcy exclusion takes precedence over all other statutory exclusions. *Id.* § 108(a)(2).

personal residence indebtedness where the discharge occurs between 2007-2014.⁷² In addition, there is no indication in the legislative history that Congress intended to reject either the (1) gift exception or the (2) bona fide debt exception to the realization of COD income.

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

- i. Gifts exception
- ii. Indebtedness subject to bona fide dispute exception
- iii. Lost deduction exception
- iv. Purchase price adjustment
- v. Contribution of capital exception
- vi. Stock-for-debt exception
- vii. Partnership equity-for-debt exception

Because many of these exceptions were fashioned from case law and predate the enactment of the BTA, a recurring question is whether the codification of a form of the exception effectively repeals all other variations of the exception. I say no. First, the legislative history to the BTA does not suggest that the codification of, for example, the purchase price adjustment repealed all variations that existed under case law. To the contrary, sufficient statements in the legislative history suggest that to the extent not inconsistent with specific provisions in section 108, case law variations of the exceptions retain their vitality. Second, treating the codification of the exceptions as “safe-harbors” does not disturb the overall purposes of section 108. Third, recognizing the exceptions effectuates sound bankruptcy and tax policy.⁷³

⁷² *Id.* § 108(a)(1)(D).

⁷³ For a persuasive discussion on the continued viability of judicial-crafted exceptions to the realization of COD income, particularly in the context of purchase price adjustments, see Stern, *supra*, at A-6.

A. GIFTS EXCEPTION

Under case law existing prior to enactment of the BTA, no COD income was realized when the cancellation of a debt was intended as a gift.⁷⁴ Although essentially nonexistent in the business context, the gifts exception does have application in limited situations.

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

Interestingly, although the result that no COD income is realized is sensible, the result must be reached outside the statutory language in IRC §108. There is no statutory gift exception or meaningful definition of *discharge of indebtedness* that would shed light on the existence of the exception. One must leave the confines of the statute to reach what all would agree to be a rational result. Thus, the failure of IRC §108 to provide a precise definition of *discharge of indebtedness* should not affect the conclusion that no COD income is realized even though the original transaction was a loan.

B. INDEBTEDNESS SUBJECT TO BONA FIDE DISPUTE EXCEPTION

Under prior case law, no COD income was realized when the cancellation of indebtedness was a result of a bona fide disputed debt.⁷⁵

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

⁷⁴ Tatlock, *supra*, at A-14. For an extended discussion of the gifts exception, see McQueen and Williams, *supra*.

⁷⁵ McQUEEN & WILLIAMS, *supra*, § 20.18.

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

Reviewing the example given, one should notice that a bona fide dispute over the existence of the indebtedness did exist between Taxpayer and Plumber. Contrast that situation with the situation where a dispute exists between Taxpayer and Plumber as to the *collectability* of the indebtedness as opposed to its *existence*. Disputes as to collectability, regardless of the bona fides present, do not fall within the exception.⁷⁶

Two related exceptions arise where a liability is too contingent⁷⁷ or is, in fact, an equity infusion rather than the creation of indebtedness.⁷⁸ In both situations, any discharge or satisfaction at a discount does not result in the realization of COD income.

C. LOST DEDUCTION EXCEPTION

Where the payment of a liability would give rise to a deduction such as the payment of interest on a business loan or the payment of trade payables, the discharge of that liability does not result in income realization.⁷⁹ Accordingly, no COD income will arise where, for example, a

⁷⁶ For an extended discussion of the bona fide dispute exception, see McQueen and Williams, *supra*, at § 20.18.

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

⁷⁸ See Stern, *supra*, at A-5. In *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985), the court held, that notwithstanding the form of the transaction, a fact issue was generated as to whether a loan to the S corporation guaranteed by a shareholder may be recharacterized as a loan to the shareholder followed by a contribution to the S corporation. For a list of factors courts consider in determining whether an advance to an entity should be characterized as equity or debt, see *In re Lane*, 742 F.2d 1311 (11th Cir. 1984); *Mixon Est. v. United States*, 464 F.2d 394 (5th Cir. 1972).

⁷⁹ IRC §108(e)(2). See Albert J. Cardinali & David C. Miller, *Tax Aspects of Non-Corporate Single Asset Bankruptcies and Workouts*, 1 AM. BANKR. INST. L. REV. 87, 95 (1993) (stating COD income is not realized if discharged liability would have been deductible).

creditor of a cash basis debtor forgives a debtor's liability for unpaid interest on a business obligation.⁸⁰ Moreover, where an obligation of the partnership would give rise to a corresponding deduction when paid, no deemed distribution to the partners under IRC §752 occurs. For the most part, this exception to COD income is self-explanatory and supported by sound tax policy. The exception avoids the inconvenience of having to report COD income and an equivalent deduction on a debtor's return.⁸¹

The lost deduction exception, however, does not apply where an accrual taxpayer has previously taken a deduction for the amount later discharged except where the deduction did not benefit the taxpayer.⁸² Thus, an accrual basis taxpayer must realize COD income from the discharge of accrued but unpaid interest, trade payables, or taxes, but only to the extent the taxpayer received tax benefits from the accruals.⁸³

D. PURCHASE PRICE ADJUSTMENT

Under IRC section 108(e)(5), any purchase price debt adjustment otherwise resulting in COD income for qualified *solvent* debtors is treated as a purchase price adjustment of the property which was financed, and accordingly, does not generate COD income.⁸⁴ The effect of this exception is a reduction in the basis of the purchased property. The stated purpose of this exception is to eliminate disputes between taxpayers and the IRS concerning what debt reductions constitute

⁸⁰ Cardinali & Miller, *supra*, at 95. This is not the case if the debtor is an accrual basis taxpayer because the deduction for such interest would have already accrued prior to payment. *Id.*

⁸¹ For an extended discussion on the lost deduction exception, see McQueen and Williams, *supra*, at §20.18.

⁸² See *Retail Properties, Inc., v. Commissioner*, T.C. Memo 1964-245; see also Stern, *supra*, at A-12.

⁸³ Stern, *supra*, at A-13 - A-14.

⁸⁴ IRC §108(e)(5). "When a debt arises out of the purchase of property, the discharge may be treated as a reduction of the purchase price, rather than as income." Grant W. Newton and Gilbert D. Bloom, *Bankruptcy & Insolvency Taxation* 45 (2d ed. 1994).

true purchase price adjustments as opposed to COD income.⁸⁵ A pressing question is whether to allow similar treatment for title 11 and insolvent debtors as well. If allowed, taxpayers may avail themselves, in these situations, of the purchase-price exception to the realization of COD income without the requirement of reducing their tax attributes under IRC section 108(b). Possibly, expanding the exception to include insolvent and title 11 taxpayers would go even further in eliminating disputes between taxpayers and the IRS.⁸⁶

A lingering issue is whether section 108(e)(5) completely supplants or augments the judicial purchase price adjustment. Prior to the enactment of the BTA, both the IRS and courts recognized a purchase price adjustment exception to the realization of COD income.⁸⁷ Moreover, in *Fulton Gold Corp. v. Commissioner*,⁸⁸ the court held that a discharge of nonrecourse secured indebtedness resulted in a nontaxable reduction in basis of the collateral. For the *Fulton Gold* doctrine to apply, the debtor must have retained the collateral and the debt must have been included in the basis of the property.⁸⁹ Although controversial, many commentators assert the continued vitality of the *Fulton Gold* doctrine.⁹⁰ Additionally, the IRS examined the continued existence and

⁸⁵ H.R. REP. NO. 833, *supra*, at 13, *reprinted in* 1980 U.S.C.C.A.N. at 56; S. REP. NO. 1035, *supra*, at 16, *reprinted in* 1980 U.S.C.C.A.N. at 7031.

⁸⁶ Neither IRC § 108 nor the committee reports address what should be done when the debt reduction amount exceeds the basis of the applicable property. This situation could arise, for example, when an accelerated depreciation method has been used for the purchased asset, or when the basis of the property has been adjusted downward as a result of a casualty loss. It would seem that the taxpayer would either have to recognize income despite section 108(e)(5) or else reduce the basis of the property below zero. Since a negative basis would be an anomaly in the tax law--an exception is the excess loss account in the consolidated return regulations, Treas. Reg. § 1.1502-19 -- income recognition would appear to be the better result here. Such income could presumably be avoided by a qualified debtor's reduction of basis in depreciable property under section 108(a)(1)(C), (c).

⁸⁷ *See, e.g.*, Rev. Rul. 91-31, 1991-1 C.B. 19; Rev. Rul. 82-202, 1982-2 C.B. 35; *see also Commissioner v. Killian Co.*, 128 F.2d 433 (8th Cir. 1942); *Hextell v. Huston*, 28 F. Supp. 521 (S.D. Iowa 1939).

⁸⁸ 31 BTA 519 (1934).

⁸⁹ *See generally* Stern, *supra*, at A-6.

⁹⁰ *See, e.g.*, Green and Sparkman, *Consequences of Discharges of Nonrecourse Indebtedness*, 67 J. Tax'n 18 (July 1987).

application of the judicial purchase price adjustment in a Revenue Ruling.⁹¹ Other hints exist that suggest the continued vitality of the judicial purchase price exception.⁹²

E. CONTRIBUTION OF CAPITAL EXCEPTION

One of the more dramatic changes to prior law made by the BTA is the contribution-of-capital exception to the realization of COD income.⁹³ Before enactment of the BTA, courts held that COD income was not realized where a shareholder's debt was cancelled as a contribution of capital.⁹⁴ This was the case even where the corporate debt had been previously deducted.⁹⁵

Section 108(e)(6)(A) significantly restricts prior law by providing that when a corporation obtains its indebtedness from a shareholder as a capital contribution, IRC § 118's tax-free treatment shall not apply.⁹⁶ A corporate taxpayer is treated as satisfying the debt by an amount of cash equal to the shareholder creditor's adjusted basis in the debt.⁹⁷ Thus, the COD rules in IRC § 108 apply only to the excess of the face amount of the obligation over the adjusted basis of the obligation in the hands of the shareholder. Treatment of this face amount will depend upon a corporate debtor's status as a title 11, insolvent, or qualified debtor.⁹⁸ While the term "contribution to capital" is not defined in the statute, the Senate Report to the BTA does indicate that a

⁹¹ Rev. Ruling 92-99, 1992-2 C.B. 35.

⁹² See, e.g., *Sutphin v. United States*, 88-1 USTC &9269 (Cl. Ct. 1988).

⁹³ IRC § 108(e)(6).

⁹⁴ E.g., *Putoma Corp. v. Commissioner*, 66 T.C. 652, 665 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979). For a detailed discussion of the exception as it existed prior to the BTA, see MCQUEEN & WILLIAMS, *supra*, § 21.15.

⁹⁵ *Putoma*, 66 T.C. at 665-66.

⁹⁶ IRC § 108(e)(6)(A); see H.R. REP. NO. 833, *supra*, at 15 n.21; S. REP. NO. 1035, *supra*, at 19 n.22, *reprinted in* 1980 U.S.C.C.A.N. at 7034.

⁹⁷ IRC § 108(e)(6)(B).

⁹⁸ H.R. REP. No. 833, *supra*, at 15; S. REP. No. 1035, *supra*, at 18 n.21, *reprinted in* 1980 U.S.C.C.A.N. at 7033.

shareholder's cancellation of debt must be related to her status as a shareholder and not to her status as a creditor attempting to recover her claim.⁹⁹

Does the capital contribution exception apply where a partner forgives a debt to the partnership? It would appear that the answer should be yes. The consequences of recognizing the exception should turn on whether the partner forgiving the debt had been allocated all of the debt under IRC §752. If so, then it should follow that only the forgiving partner receives a deemed distribution in cash.¹⁰⁰ However, if the partnership debt has been allocated to all the partners, then all partners receive a deemed distribution in cash¹⁰¹

F. STOCK-FOR-DEBT EXCEPTION

One of the most controversial issues involving exceptions to the realization of COD income has been the existence and application of the stock-for-debt exception. Stock-for-debt exchanges are an historical exception to the recognition of COD income.¹⁰² Under this exception, if a corporate debtor issued stock in exchange for debt, no COD income arose even when the stock was worth less than the debt satisfied.¹⁰³ The theory that led to the implementation of this

⁹⁹ S. REP. No. 1035, *supra*, at 19 n.22, *reprinted in* 1980 U.S.C.C.A.N. at 7034.

¹⁰⁰ IRC §752(b).

¹⁰¹ *Id.*

¹⁰² *See Commissioner v. Motor Mart Trust*, 156 F.2d 122, 127 (1st Cir. 1946) (holding conversion of bonds into stock was not cancellation of indebtedness); *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691,695 (1942) (recognizing stock-for-debt exchange differs from discharge of indebtedness and does not result in realization of gain), *aff'd*, 140 F.2d 382, 385 (1st Cir. 1944) (holding substitution of shares for bonds was recapitalization and not gain); Rev. Rul. 59-222, 1959-1 C.B. 80; Rev. Rul. 59-98, 1959-1 C.B. 76 (discussing exchange of stock and securities in certain reorganizations). "The cases arrived at this result under the somewhat questionable assertion that there was no satisfaction of the debt, but the issuance of the stock instead represented the creation of a new liability to substitute for the old." Asofsky, *supra*, at 600.

¹⁰³ *Motor Mart*, 156 F.2d at 127 (finding such a transaction "a form of payment for the bonds "rather than cancellation of indebtedness).

exception was that the substitution of stock for debt continued a creditor's interest in the corporate debtor.¹⁰⁴

The stock-for-debt exception to COD income has been repealed by the Omnibus Budget Reconciliation Act of 1993.¹⁰⁵ The controversial repeal is effective for stock transferred after 1994, except for stock transferred in a title 11 or similar case that is filed before the end of 1993.¹⁰⁶

¹⁰⁴ Mark A. Frankel, *Federal Taxation of Corporate Reorganizations*, 66 AM. BANKR. L.J. 55, 63 (1992).

¹⁰⁵ Pub. L. No. 103-66, § 13226(a), 107 Stat. 312, 487-88.

¹⁰⁶ *Id.* § 13226(a)(3).

VI. DEFERMENT OF COD INCOME: ATTRIBUTE AND BASIS REDUCTION RULES

The deferment of COD income is not cost-free. To the extent COD income is excluded under section 108(a), the COD income must be used to reduce enumerated tax attributes listed in section 108(b)(2).¹⁰⁷ Section 108(b)(2) lists the tax attributes to be reduced in the following order:

- (1) net operating losses for the taxable year of discharge and any net operating loss carryover;
- (2) any carryover of general business tax credits under IRC §38;
- (3) any minimum tax credits under IRC § 53(b) as of the tax year immediately following the taxable year of discharge;
- (4) any net capital-losses for the taxable year of discharge and any capital loss carryovers;
- (5) basis in all the taxpayer's property;
- (6) any passive activity loss or credit carryover under IRC §469(b) for the taxable year of discharge;
- (7) any foreign tax credit carryovers.¹⁰⁸

Section 108(b)(4) contains ordering rules by which attributes are reduced. Attribute reduction is made after determining any tax for the tax year of discharge in question.¹⁰⁹ Carryovers reduce COD income dollar for dollar. Credits reduce COD income 33 1/3 cents for every dollar of COD income.¹¹⁰ For net operating losses and capital loss carryovers, the reduction is applied first to the loss occurring during the taxable year of the discharge and subsequently to carryovers in the sequence in which such carryovers arose.¹¹¹ For credits, the reduction is applied in the order

¹⁰⁷ IRC § 108(b)(1); *see* Tatlock, *supra*, at A-19 to A-28(1) (discussing ramifications of attribute reduction); Stern, *supra*, at A-7 - A-8(1).

¹⁰⁸ IRC § 108(b)(2).

¹⁰⁹ IRC § 108(b)(4)(A).

¹¹⁰ IRC § 108(b)(3)(B).

¹¹¹ IRC § 108(b)(4)(B).

the credits would have been applied against tax liability,¹¹² without regard to any income limitations on the use of the credits.¹¹³

Because of the forced reduction in attributes, section 108 is theoretically a rule of tax deferment and not outright exclusion. Most often, this is an illusory concept. If any COD income exists after all tax attributes in IRC §108(b) are reduced, the remaining COD income is forever excluded.¹¹⁴

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

¹¹² *Id.* § 108(b)(4)(C).

¹¹³ H.R. REP. NO. 833, *supra*, at 8, S. REP. No. 1035, *supra*, at 13, *reprinted in* 1980 U.S.C.C.A.N. at 7028.

¹¹⁴ *See* Kenneth C. Weil, *Effects of Real Property Abandonments in Bankruptcy*, 70 J. TAX'N 358, 358 (1989) (stating that section 108 exclusions operate as deferral only if a tax attribute "that has been reduced could have been used").

bankruptcy case.¹¹⁵ Eight, basis is reduced only to the extent of the excess of the aggregate of the bases of the property held by the taxpayer immediately after discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.¹¹⁶ Thus, if the remaining liabilities immediately after the discharge exceed the aggregate basis in property held by the taxpayer immediately after the discharge, then no basis reduction is necessary. However, if the aggregate basis in property held by the taxpayer exceeds the remaining liabilities immediately after the discharge, then basis reduction is necessary to the extent of remaining liabilities.¹¹⁷

An insolvent or title 11 taxpayer may elect under IRC §108(b)(5) to reduce the basis of its depreciable property by the amount of COD income before reducing tax attributes under section 108(b).¹¹⁸ Depreciable property includes any property subject to a depreciation allowance, but only if a basis reduction will also reduce the amount of depreciation or amortization allowable in the period subsequent to the reduction.¹¹⁹ Furthermore, a taxpayer may elect to include as depreciable property, real property held as inventory.¹²⁰ If the election is made, attributes are reduced in the following order:

1. Tax basis in depreciable property to zero basis;

¹¹⁵ See generally Treas. Reg. §1.1017-1.

¹¹⁶ IRC §1017(b)(2).

¹¹⁷ However, if a taxpayer elects to reduce basis in depreciable property under IRC §108(b)(5), then the limitation in IRC §1017(b)(2) does not apply.

¹¹⁸ IRC § 108(d)(5).

¹¹⁹ *Id.* § 1017(b)(3)(B).

¹²⁰ *Id.* § 1017(b)(3)(E). The election may either be made on the debtor's return for the taxable year of the discharge or in accordance with any regulations which may be issued, and may be revoked only with the consent of the Secretary of the Treasury. *Id.* § 1017(b)(3)(E)(ii). If the taxpayer establishes a reasonable cause for failure to file the election with the original return, the election may be filed with an amended return or claim for credit or refund. Temp. Treas. Reg. § 301.9100-14T (as amended in 1992). In addition, when a debtor corporation owns stock in another corporation and both corporations are members of an affiliated group filing a consolidated return for the year of the discharge, the subsidiary's stock is considered depreciable property if the subsidiary consents to a corresponding adjustment to its basis in depreciable property. IRC § 1017(b)(3)(D). Similarly, a partner's interest in a partnership can be depreciable property for this purpose to the extent of that partner's proportionate interest in depreciable property held by the partnership, but only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to that partner. *Id.* § 1017(b)(3)(C).

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

VII. MORTGAGE FORECLOSURES

Foreclosure has been a hot topic and an often discussed matter over the last several years. Many attorneys, some of whom had never done a foreclosure previously, have become quite experienced and proficient with foreclosure actions and confirmation hearings, where applicable. Discussed less often, and perhaps less understood, are the potential tax ramifications that may flow from a foreclosure or a “short sale.” This section of the outline will provide a primer on the tax consequences, and a look at a few examples of the more likely scenarios that one may encounter outside of a bankruptcy case.

A few overarching legal principles must be understood before embarking on the examples set forth below. Two of these principles - that cancellation of debt generates income, and that of the exclusion of gain from the sale of a primary residence under IRC section 121 - have been around for some time and are likely to remain. The third legal principle, the exclusion of COD income under certain circumstances, has been available only since 2007, and was extended through December 31, 2014.¹²¹

A. COD GENERATES TAXABLE INCOME

As a general rule, COD for which a taxpayer is personally liable will result in taxable income to that taxpayer. Since virtually all home purchases using loans involve recourse indebtedness, the COD provisions generally will apply to home foreclosures and short sales.

The policy for the present treatment of COD can easily be justified. The borrower with COD achieves in essence what is often referred to as “wealth accession.” He may have received

¹²¹ See IRS Publication 4681.

a sum equal to the amount cancelled or forgiven by having his debt “paid” for him or on his behalf by another.

In theory, this COD policy for the most part seeks to place comparable taxpayers on an equal footing but, in fact, does not go quite far enough to achieve the goal of horizontal equity. Compare two taxpayers – one of whom saves \$100,000. In order to save this amount of money that taxpayer likely would have had to earn and pay taxes on \$120,000 to \$135,000 of income. This taxpayer utilizes the \$100,000 as a 50% down payment on a home.

The second taxpayer does not have any savings, but desires to purchase a comparable priced home, borrowing the full \$200,000. Since the second taxpayer is liable for the repayment of this debt, it is not viewed as income, but solely as an increase in his debt load.

A year after each has purchased his home, financial catastrophe strikes, and each of the homes is foreclosed at a bid price of \$100,000. The net effect to the lender for each is \$100,000 at the foreclosure sale, leaving a deficiency of \$100,000. At this point, neither owner has anything. Owner 1 has lost his home along with his initial \$100,000 in equity. Owner 2 has lost his home, but had no initial equity in the home and the deficiency of \$100,000 is forgiven or canceled. The net economic effect is Owner 2 has lost nothing. The forgiveness has put Owner 2 on equal footing with Owner 1 – each receiving the “benefit” of losing \$100,000 - but only Owner 1 was required to pay taxes on that \$100,000.

Under these circumstances, Owner 2 would generally be required to recognize \$100,000 in income and pay tax on that amount. Though this may come as a heavy burden, Owner 2 is still actually receiving more favorable treatment. Owner 2 merely recognizes the amount of debt forgiven – the \$100,000 – and pays his marginal tax rate on that amount. Owner 1’s lost \$100,000

was after-tax monies, meaning Owner 1 likely had to pay taxes on an amount significantly more than \$100,000

B. GAIN FROM SALE OF PRINCIPAL RESIDENCE EXCLUDED FROM INCOME

Under IRC section 121 a taxpayer is permitted to exclude from income any gain up to \$250,000 (\$500,000 for certain married taxpayers) resulting from a sale of their primary residence. Section 121 is satisfied if a taxpayer owns and resides in the primary residence aggregating at least two of five years preceding the sale or exchange.

This exclusion from income would have no effect on the above scenario, since neither taxpayer had gain. In fact, each indeed had an actual loss. Owner 2 did have income (\$100,000), but no gain. However, there are some settings where this exclusion may be able to be utilized by a taxpayer that has received COD income from a loan modification that reduces a portion of the outstanding debt principal. (*See example below*).

C. THE MORTGAGE FORGIVENESS DEBT RELIEF ACT EXAMPLES

The Mortgage Forgiveness Debt Relief Act of 2007 [extended through tax year 2014 with bills in Congress to extend through 2016] (“MFDRA”) applies only to forgiven, canceled, or restructured mortgage debt during calendar years 2007 – 2014 [with bills pending in Congress to extend the MFDRA through 2016] on a primary residence, and not a second or investment home.¹²² This exclusion applies only to forgiven or cancelled indebtedness used to buy, build, or substantially improve the principal residence.¹²³ Moreover, the debt must be secured by the main home. Debt incurred through refinancing poses an additional complexity. If the refinancing

¹²² IRC §108(h); IRS Publication 4681; IRS Form 982.

¹²³ IRC §108(h)(2).

relates to the principal balance of an old mortgage that itself would have qualified under this exclusion, then the refinancing qualifies.¹²⁴

The exclusion can be quite substantial, since the law allows up to the maximum exemption amount of \$2 million (\$1 million if married filing separately).¹²⁵ At the top marginal tax rate of about 40%, this could result in a tax savings of \$800,000.

Usually, a lender (the typical counter-party to these transactions) reports the COD to the IRS and the taxpayer on a Form 1099-C, specifically box 2. If the amount in box 2 of Form 1099-C is incorrect, a taxpayer should quickly contact the lender that issued the Form 1099-C and have it corrected and a corrected Form 1099-C issued to the IRS and the taxpayer.

If a taxpayer employs the qualified principal residence indebtedness exclusion under section 108(a)(1)(e) and (h), he must report the excluded amount on IRS Form 982.¹²⁶ This Form must be attached to his return. There is no requirement that the taxpayer fill out the complete Form 982; rather, a taxpayer usually need only fill out lines 1e, 2, and 10b (this last entry if the taxpayer retained ownership in the main home).¹²⁷

If a taxpayer excludes forgiven qualified principal indebtedness from income and continues to own the main home, he must reduce the basis in the main home by the amount of the canceled qualified principal residence indebtedness actually excluded from income.¹²⁸ In no case should the basis in the main home be reduced below zero. A taxpayer enters the amount of any basis reduction on line 10b, Form 982.

¹²⁴ IRS Publication 4681.

¹²⁵ IRC §108(h)(2).

¹²⁶ IRS Publication 4681.

¹²⁷ IRS Publication 4681.

¹²⁸ IRS Publication 4681.

These are the basic principles to keep in mind while working through the common scenarios set forth below.

1. Scenario 1 (Typical Foreclosure)

Foreclosure on home that has declined below the value of the balance of the purchase money mortgage AND acquisition cost:

Purchase price of Home:	\$400,000
Initial Loan Balance:	\$380,000 (LTV ratio of 95%)
Value at time of Foreclosure:	\$290,000
High Bid at Foreclosure:	\$200,000
Deficiency:	\$180,000

Lender elects not to, or denied the ability to pursue deficiency:

Recourse Debt (Property in Satisfaction of Debt):

$$\text{Gain (Loss)} = \text{FMV} - \text{Basis}$$

$$\text{COD} = \text{Debt} - \text{FMV}$$

Nonrecourse Debt (Property in Satisfaction of Debt):

$$\text{Gain (Loss)} = \text{Debt} - \text{Basis}$$

$$\text{COD} = \$0$$

Amount of Debt Forgiven/COD: \$180,000 (this constitutes \$180,000 of income)

MFDRA exclusion: \$180,000

Basis reduction: \$0 (taxpayer no longer owns home)

Result: No additional tax due if forgiveness (not the foreclosure) occurs before expiration of the MFDRA. IF the MFDRA does not apply, either because this was an investment property, second home, or MFDRA had expired, this debt forgiveness could result in a tax liability of up to \$63,000. Note that in this Scenario, the FMV at the time of the foreclosure was \$290,000, but the high bid was only \$200,000. The COD is determined based on the FMV of the property, which is presumed to be the accepted bid price at the foreclosure sale absent fraud or collusion.

2. Scenario 2 (Cash Out)

Foreclosure of home that has increased in value of the acquisition cost but below the outstanding loan balance of the debt secured by the home. This scenario typically results from a cash-out type refinancing. Here we must deal with the potential for a possibility of both gain and debt forgiveness.

Under the MFDRA, only that portion of the forgiven debt pertaining to the purchase (or construction or improvement) of the primary residence qualifies for exclusion. Consequently, any debt attributable to the “cash out” will constitute income that does not qualify for the exclusion.

Purchase price of Home:	\$400,000
Initial Loan Balance:	\$380,000 (LTV ratio of 95%)

Subsequently, the home increases in value to \$600,000, and the owner borrows an additional \$200,000:

Balance after refinancing:	\$600,000
Value at Time of Foreclosure /High Bid at Foreclosure:	\$475,000
Deficiency:	\$125,000
Gain:	\$75,000

Lender elects not to, or denied the ability to, pursue deficiency:

COD:	\$125,000 (constitutes \$125,000 of income)
MFDRA exclusion:	\$0 (the amount forgiven is less than the non-purchase portion of the loan balance, \$200,000)
Basis reduction:	\$0 (taxpayer no longer owns home)

In this scenario, the \$75,000 is excluded as IRC section 121 gain, so no tax is due on that portion. The COD income of \$125,000, however, does not qualify for exclusion under the MFDRA because of the “ordering rule.” “If only a part of the loan is qualified principal residence

indebtedness,¹²⁹ the exclusion applies only to the extent the amount canceled is more than the amount of the loan (immediately before the cancellation) that is not qualified principal residence indebtedness.” Additionally, the COD does not qualify for the IRC section 121 exclusion, which is a capital gain exclusion. Income from debt forgiveness is ordinary income, not capital gain.

Result: Absent insolvency or in bankruptcy issues, a tax liability on \$125,000 of income accrues.

3. Scenario 3 (Home Retained)

Modification of Indebtedness involving Forgiveness of Debt; Ownership of Home Retained: A portion of the outstanding principal is forgiven in the loan renegotiation, and the home price partially or completely recovers later.

Purchase Price of Home:	\$400,000
Initial Loan Balance:	\$380,000 (LTV ratio of 95%)
Value time of Foreclosure:	\$250,000

Now assume a modification of the indebtedness reducing the principal balance to \$250,000 and forgiving the remaining \$130,000. Subsequent to the modification, five years pass, value of home rises to \$430,000. Home sold for \$430,000. When the forgiveness of the \$130,000 occurred it constituted forgiveness of debt, but it was excluded under the MFDRA. However, the forgiveness required that the basis in the property be reduced by the amount excluded under IRC section 108(a)(1)(e). Thus, this appears to be more a rule of tax deferment and not outright exclusion.

Basis before modification:	\$400,000
Less loan forgiveness:	(\$130,000)
Basis after §108 application:	\$270,000

¹²⁹ Qualified principal residence indebtedness includes only the debt used to buy, build, or improve a taxpayer’s main home. IRC §163(h)(3)(B).

Sales proceeds:	\$430,000
Less adjusted basis:	(\$270,000)
Gain:	\$160,000

Under this scenario, there is a larger degree of gain because of the COD. However, IRC section 121 would permit the exclusion of the entire gain. Nevertheless, taxpayer may not entirely avoid paying any tax. In the event the gain at the time of the sale exceeds the amount of gain excluded by IRC section 121, a more likely occurrence with the reduction of the basis, the taxpayer may be liable for the gain. However, even if that be the case, the timing of any tax liability for the gain related to the COD exclusion has been significantly deferred.

D. MOVEMENT TO BANKRUPTCY

As discussed, a material modification of a home mortgage, a short sell, or a foreclosure may give rise to either COD income, section 1001 gain, or both. Well-established principles guide the resolution of these issues outside of bankruptcy. In bankruptcy, matters become more complex: who owes a tax; whether COD must be realized and recognized and by whom; whether gain is present; and, if a tax does exist, whether that tax is nondischargeable in a bankruptcy case are all questions that are top of mind. Parts VIII and IX address these issues.

VIII. IRC SECTION 1398: THE SEPARATE ENTITY RULES

One of the most important provisions of the BTA is IRC section 1398. Essentially, section 1398 creates a separate entity for purposes of federal income taxes in cases where an individual debtor files for relief under chapter 7 or chapter 11 of the BC. Following is a list of common questions and answers regarding the scope, purpose, and effect of section 1398.

A. WHEN DOES IRC SECTION 1398 APPLY?

Section 1398 applies only when an individual debtor files for relief under chapter 7 or chapter 11 of the BC. Thus, only the bankruptcy estate of an individual debtor in cases under chapter 7 or 11 is treated as a separate taxable entity. A separate taxable entity is not created in chapters 12 or 13 or in any case where the debtor is not an individual.¹³⁰

B. WHAT IS THE PURPOSE OF IRC SECTION 1398?

Section 1398 furthers the fresh start policy embodied in the BC. The Committee Reports recognize that the purpose of bankruptcy is to provide for a debtor's ability to begin his or her economic life anew.¹³¹ Congress recognized that any expenses incurred by the estate should not burden a debtor's fresh start. Consistent with this purpose is the fact that the income and losses of a separate taxable entity are computed separately from the individual debtor. Moreover, any estate tax liability is generally confined to the estate and its assets. Furthermore, by making the short-

¹³⁰ IRC §§ 1398(a), (b), and 1399.

¹³¹ S. Rep. No. 1035, 96th Cong., 2d Sess. 24-25 (1980); *see generally* Jack F. Williams, *A Comment on the Tax Provisions of the National Bankruptcy Review Commission Report: The Good, The Bad, and The Ugly*, 5 Am. Bankr. Inst. L. Rev. 445-462 (1997)(symposium); Jack F. Williams, *National Bankruptcy Review Commission Recommendations on Tax Policy: Individual Debtors, Discharge, and Priority of Claims*, 14 Bankr. Dev. J. 101-171 (1997); Jack F. Williams, *The Federal Tax Consequences of Individual Debtor Chapter 11 Cases*, 46 S.C. L. Rev. 1203-1244 (1995)(symposium), *reprinted in* 47 Digest of Tax Articles 23-43 (1996); Jack F. Williams, *Rethinking Bankruptcy and Tax Policy*, 3 Am. Bankr. Inst. L. Rev. 153-206 (1995)(symposium); *see also* Robert W. Van Amburgh, *Tax Considerations For An Individual Debtor Contemplating Bankruptcy*, Annals Bankr. L. 93, 121-28.

year election, a debtor may be able to shift at least part of his or her tax liability to the estate as a BC section 507(a)(8) priority claim.¹³²

C. HOW IS THE BANKRUPTCY ESTATE TAXED UNDER IRC SECTION 1398?

Consistent with its separate entity status, an estate computes its own taxable income in the same manner as an individual.¹³³ The estate is taxed at the same rate as a married individual filing separately.¹³⁴ The chapter 7 or 11 trustee is required to file any returns required by law and to pay any taxes due. The trustee must file a return for each taxable year that the estate's gross income exceeds the standard deduction and the exemption amount.¹³⁵

D. MUST A TRUSTEE FILE A FEDERAL TAX RETURN WHERE THE ESTATE HAS GENERATED NO INCOME?

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

E. HOW IS THE GROSS INCOME OF A BANKRUPTCY ESTATE DETERMINED?

The bankruptcy estate's gross income includes the gross income of the debtor to which the estate is entitled under §§ 541(a)(1) through (a)(7). Property of the estate includes all of the debtor's legal or equitable interest in property wherever located. Section 1398 does not permit double counting of income or losses by both the estate and the debtor. Thus, section 1398(e)(2) provides that a debtor's gross income for any taxable year does not include any item to the extent it is included in the estate's gross income.¹³⁶

¹³² See IRC § 1398(d); *see also* 1A Collier on Bankruptcy & 9.05 (15th ed. L. King ed.).

¹³³ IRC § 1398(c)(1).

¹³⁴ IRC §§ 1398(c)(2) and (c)(3).

¹³⁵ See Van Amburgh.

¹³⁶ See *generally* 1A Collier on Bankruptcy at & 9.04[3].

F. HOW IS INCOME TREATED WHERE EARNED PREPETITION, BUT RECEIVED POSTPETITION?

Section 1398(e)(1) provides that gross income of the estate does not include any amount received or accrued by the debtor before the commencement of the case. Thus, section 1398 was intended to override the assignment-of-income principles under tax law. An example may clarify the effect. Assume that a cash-basis individual who draws a weekly salary nonexempt under applicable state law earns one payment prior to the commencement of his or her chapter 7 case, but it is received by the estate after commencement. In that case, the estate and not the debtor would report the income.¹³⁷

G. HOW IS COD INCOME TREATED UNDER THE SEPARATE ENTITY RULES?

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

H. HOW ARE DEDUCTIONS TREATED UNDER THE SEPARATE ENTITY RULES?

Section 1398(e)(3) provides that the determination whether any amount paid or incurred by the estate is allowable as a deduction shall be made as if paid by the debtor and the debtor was

¹³⁷ See Van Amburgh at 123 (provides examples of cash-basis and accrual-basis debtors).

still engaged in the trade or business that the debtor was engaged in before the commencement of the case. It would appear that the same accounting method used for income should be used for deductions. Additionally, section 1398(e)(3) permits the estate to characterize some of its expenditures as trade or business expenses which can be used to offset current income of the estate. Furthermore, administrative expenses and any fees under chapter 123, Title 28, United States Code, are deductible by the estate to the extent not disallowed under another IRC section.¹³⁸ If the administrative expenses cannot be used in the current year then they may be carried back three years and carried forward seven years.¹³⁹

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

No. Transfers of assets from the debtor to the estate upon commencement of the case and from the estate to the debtor upon termination of the estate are not taxable events.¹⁴⁰

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

Yes. The estate succeeds to certain enumerated tax attributes of the debtor upon commencement of the case.¹⁴¹ Presently, these tax attributes include net-operating loss carryovers as determined under IRC section 172; excess charitable contribution carryovers as determined under IRC section 170(d)(1); the recovery of tax benefit items under IRC section 111; certain credit carryovers; capital loss carryovers determined under IRC section 1212; the basis, holding period, and character of property; the debtor's method of accounting; and other tax attributes of

¹³⁸ IRC § 1398(h)(2).

¹³⁹ IRC § 398(h)(2)(C).

¹⁴⁰ IRC § 1398(f).

¹⁴¹ See IRC § 1398(g).

the debtor, to the extent provided in regulations carrying out the purposes of section 1398.¹⁴² The Service has issued regulations adding passive activity losses and credits to the list¹⁴³ and the section 121 exclusion of gain from the sale of a personal residence transferred to the estate.¹⁴⁴ Upon termination of the estate, any unused attributes are transferred back to the debtor.¹⁴⁵

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

Section 1398(d)(2) creates an election that a debtor may make to split his or her taxable year into *two* taxable years. This election is an important pre-bankruptcy planning tool that cannot be overlooked. The first taxable year-ends on the day before the day the bankruptcy case was commenced.¹⁴⁶ The second taxable year begins on the commencement date. Assume an individual debtor files for relief under chapter 7 on March 8 and shortly thereafter makes the IRC § 1398(d) election. As a consequence of the election, the debtor has two tax years. The first year spans from January 1 through March 7; the second year spans from March 8 through December 31. If the election is not made the debtor would have one taxable year spanning from January 1 through December 31. In other words, absent the election, the commencement of the case will not interrupt the debtor’s taxable year.¹⁴⁷ The short-year election is considered made if the complete tax return for the short period is timely filed.¹⁴⁸ In our working example, the return for the short period

¹⁴²See McQueen and Williams, *supra* (helpful explanation of the listed attributes).

¹⁴³See Treas. Regs. §§ 1.1398-1 and 1.1398-2.

¹⁴⁴See Treas. Reg. § 1.1398-3.

¹⁴⁵IRC § 1398(I).

¹⁴⁶A bankruptcy case is commenced upon the filing of the petition under BC §§ 301, 302, and 303.

¹⁴⁷See IRC § 1398(d)(1). The debtor cannot make the short-year election if he or she has no assets other than exempt property. IRC § 1398(d)(2)(C).

¹⁴⁸See Temp. Treas. Reg. § 7a.2(d) (1981); Treas. Reg. § 1.6081-1(b)(2).

ending March 7 should be filed by July 15. The debtor should conspicuously write “**SECTION 1398 ELECTION**” at the top of the return.¹⁴⁹

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

The short-year election must be made by the debtor on or before the date for filing his or her return for the short-taxable year.¹⁵⁰ IRC section 6072 requires that returns be made on or before the fifteenth day of the fourth month following the close of a fiscal year. A Treasury Regulation places a gloss on section 6072 in this context by requiring that the short-term return be filed on or before the fifteenth day of the fourth full month following the close of the taxable year.¹⁵¹ Again, the election must be made on the return. Once made, the election is irrevocable.¹⁵²

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

The short-year election may be the most potent pre-bankruptcy planning tool because of its wide availability to individual debtors. The most significant effect of the election is that any tax liability for the first short-year becomes an allowed BC section 507(a)(8) priority claim against the estate. Thus, the debtor may essentially force his or her unsecured creditors to pay all or a portion of the first short-year tax claim. Of course, if there are insufficient assets to pay the short-year tax claims in full, they do survive the bankruptcy as a non-dischargeable claim under BC section 523(a)(1). If the debtor fails to make the election, then any tax liability for the complete year is not an allowable claim against the estate.¹⁵³ Moreover, if a debtor makes the election, then

¹⁴⁹Temp. Treas. Reg. § 7a.2(d) (1981). For an excellent discussion on requesting extensions to file the short-year return, see 1A Collier on Bankruptcy at § 9.05[b]. *See generally* James I. Shepard, The Trustee’s Bankruptcy Tax Manual 157-58 (recent edition).

¹⁵⁰IRC § 1398(d)(2)(D).

¹⁵¹Temp. Treas. Reg. § 7a. 2(d).

¹⁵²IRC § 1398(d)(2)(D).

¹⁵³*See* S. Rep. No. 1035, 96th Cong., 2d Sess. 26 (1980).

a debtor's tax attributes as of the end of the first taxable year are transferred to the estate to be used by the estate to shelter income. If the election is not made, a debtor's tax attributes as of the end of the full taxable year carryover.

N. WHEN IS IT ADVISABLE FOR A DEBTOR TO MAKE THE SHORT-YEAR ELECTION?

There is no easy answer to the question posed. Whether a debtor should make the IRC § 1398 election depends on the particular facts and circumstances at hand. As a general rule it appears that in most cases the election should be made.¹⁵⁴ By making the election, a debtor is able to shift at least some of the tax liability to the estate as an allowable BC section 507(a)(8) priority claim. However, if the claim is not satisfied it will be nondischargeable and survive the bankruptcy. There may be circumstances present to dissuade a debtor from making the election when substantial net operating losses are involved. For example, if the debtor will benefit more from (i) the use of a net operating loss carried forward from the first short year (if he makes the election) to directly or indirectly reduce nondischargeable tax liabilities than from (ii) the use of the net operating loss against projected income of the debtor after the filing of the petition, then the election should be made. Otherwise the election should not be made.¹⁵⁵

Nondischargeable taxes are the antithesis of an individual's fresh start. Yet, the drafters of the BC struck the synthesis in favor of the taxing authorities at least as to those tax claims identified in section 523(a)(1). Nevertheless, all is not lost for an individual debtor and his or her bankruptcy counsel in reducing possible tax consequences in contemplation of a bankruptcy filing. Although experience has shown that an individual debtor should most often make the short-year election,

¹⁵⁴Van Amburgh at 144; *see also* Shepard at 150-57.

¹⁵⁵Van Amburgh at 145; *see also* 1A Collier on Bankruptcy at § 9.05[3]; Shepard at 150-157.

there are many instances where the election should not be made. Counsel must be aware of when a debtor should make the election and when a debtor should not. Often times, there are no easy rules, no easy answers. Nevertheless, section 1398 with all its nuances and ramifications cannot be ignored before and during bankruptcy.

Example 10: THE MALPRACTICE TRAP

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

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

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

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

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

IX. DISCHARGE OF TAXES

A. SCOPE OF DISCHARGE

An individual's most important bankruptcy objective is a discharge from his or her debts.¹⁵⁶ The discharge is at the heart of the fresh start policy promoted by the BC and the BTA. The chapter 7 discharge is granted virtually automatically unless an objecting party can establish that the debtor has engaged in prohibited conduct, usually constituting some type of fraud or bankruptcy crime.¹⁵⁷ The statute providing for discharge is liberally construed in favor of an individual debtor.¹⁵⁸ Thus, the objecting party has the burden of establishing a ground for the denial of a discharge.¹⁵⁹

¹⁵⁶See generally Douglas G. Baird, *The Elements of Bankruptcy* 27-44 (1992) (discuss fresh start policy); David G. Epstein, Steve H. Nickles, & James J. White, 2 *Bankruptcy* § 7-16 (1993)(same).

¹⁵⁷See 11 U.S.C. §§ 727(a)(1) through (a)(10).

¹⁵⁸*Accord In re Adeeb*, 787 F.2d 1339 (9th Cir. 1986); *In re Johnson*, 98 BR 359 (Bankr. N.D. 1988); *In re Cutignola*, 87 BR 702 (Bankr. M.D. Fla. 1988); *In re Burke*, 83 BR 716 (Bankr. N.D. 1988); *In re Drenckhalm*, 77 BR 697 (Bankr. D. Minn. 1987); *In re Howard*, 55 BR 580 (Bankr. E.D.N.C. 1985).

¹⁵⁹If a debtor has been denied a discharge in a bankruptcy case, so that all his or her debts remain outstanding, the debtor may not include the same obligations in a subsequent case to obtain a discharge. The denial of the discharge is *res judicata* as to the obligations existing at that time, which are forever nondischargeable. Although understood as part of the warp and wolf of bankruptcy law, the right to discharge was not a part of the early enactments of bankruptcy acts in the United States. The Supreme Court noted the comparative newness of the discharge and fresh-start policy in bankruptcy in *United States v. Kras*, 409 U.S. 414, 446-47 (1973). In fact, it was not until the enactment of the Bankruptcy Act of 1898 that the law provided an individual debtor with a right to discharge certain debts pursuant to the bankruptcy process. Moreover, contrary to conventional wisdom, there is no constitutional right to a discharge; discharge is a statutory privilege provided to the honest but unfortunate debtor who has not abused the bankruptcy process. See *In re Wheeler*, 101 BR 39 (Bankr. N.D. Ohio 1988). A discharge in a bankruptcy case voids any judgment to the extent that it is a determination of the personal liability of the debtor with respect to a prepetition debt. See 11 U.S.C. § 524(a). The discharge also operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, including telephone calls, letters, and personal contacts, to collect, recover, or offset any discharged debt. *Id.* In effect, the discharge is a total prohibition on debt collection efforts against a debtor. However, a discharge of the debtor does not discharge those liable on the debt along with the debtor, including guarantors, co-makers, or partners. 11 U.S.C. § 524(e). Furthermore, under BC § 524, any attempt to reaffirm a discharged debt is void unless the provisions of the Bankruptcy Code delineating the requirements of reaffirmation are specifically followed. See 11 U.S.C. § 524(c). To ensure the effectiveness of the discharge, § 525(a) prohibits a governmental unit from denying, suspending, or refusing to renew a license or permit or deny employment solely because the person involved was discharged under the Bankruptcy Code, was insolvent before the bankruptcy case, or has not paid a dischargeable debt. Additionally, under § 525(b), no private employer may terminate the employment of, or discriminate with respect to employment against, an individual who is or has been a debtor under the Code, or an individual associated with a debtor under the Code, solely because the debtor is or has been a debtor under the Code, was insolvent before the commencement of case under the Code, or has not paid a debt that is dischargeable under the Code. See generally D. Epstein, S. Nickles, & J. White at 7-40.

Under chapter 11, section 1141(d) governs the scope and limits of discharge. Pursuant to BC section 1141(d), the confirmation of a plan of reorganization discharges a debtor from any debt that arose before the confirmation of the plan. Unlike section 727(a), a partnership, corporation, or an individual may receive a section 1141(d) discharge.¹⁶⁰ The section 1141(d) discharge is broader than the section 727(a) discharge in that the latter discharges any debts that *arose*¹⁶¹ before the *order for relief*,¹⁶² while the former discharges any debts that arose before the *confirmation of the plan*.¹⁶³

B. EXCEPTIONS OF DEBT FROM DISCHARGE

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

¹⁶⁰In *Toibb v. Radloff*, 111 S. Ct. 2197 (1991), the Supreme Court held that an individual may properly seek relief under chapter 11 of the Bankruptcy Code.

¹⁶¹It should come as no surprise that just when a debt *arises* has become a bone of contention. D. Epstein, S. Nickles, & J. White 7-16, at 312.

¹⁶²The order for relief is entered automatically where a debtor files a voluntary petition in bankruptcy. See 11 U.S.C. § 301. In an involuntary case, the order for relief comes after the court is persuaded that the grounds for involuntary relief are met. See 11 U.S.C. § 303(h).

¹⁶³For the requirements for chapter 11 plan confirmation, see 11 U.S.C. § 1129.

Section 523 of the BC generally specifies which debts of an *individual debtor* are not discharged in a bankruptcy case under section 727 of chapter 7, section 1141 of chapter 11, or section 1328(a) and (b) of chapter 13 (the “super-discharge” and the “hardship” discharge). Included among these debts are certain taxes which are identified as nondischargeable.¹⁶⁴

C. PRIORITY TAX CLAIMS

The first category of nondischargeable tax claims is set forth in section 523(a)(1)(A).¹⁶⁵ This category also happens to include the priority tax claims identified in section 507(a)(8). Thus, unlike the remaining two categories of nondischargeable tax claims, this particular category may participate in the distribution of estate assets under section 726 as a priority tax claim, in effect forcing the unsecured creditors of the estate to subsidize the tax obligation of the debtor. Therefore, it is incumbent on the debtor to ensure that such tax claim be filed by the taxing authority or to take the steps himself to file a claim on behalf of the taxing authority.

Under this section, a tax or customs duty specified in § 507(a)(3) as an involuntary gap claim¹⁶⁶ or § 507(a)(8)¹⁶⁷ is nondischargeable whether or not a claim for such tax was allowed by

¹⁶⁴ In *In re Olsen*, 123 B.R. 312 (Bankr. N.D. Ill. 1991), the bankruptcy court held that a nondischargeable tax claim survives bankruptcy regardless of whether such claim was filed or allowed in the bankruptcy case.

¹⁶⁵ 11 USC § 523(a)(1), which reads as follows:

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

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

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

(i) was not filed; or

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

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

¹⁶⁶ 11 U.S.C § 523(a)(1)(A); 11 USC § 507(a)(3)(this section relates to the priority of involuntary gap claims).

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

the court or filed in the case.¹⁶⁸ These priority and nondischargeable tax claims include the following:

1. Involuntary gap claims under § 507(a)(3).¹⁶⁹
2. Income or gross receipts taxes incurred (that is, measured by the last date by which a return could be filed without penalty) prepetition and within three years from the filing of the bankruptcy petition.¹⁷⁰ An easier approach in applying this rule is to go back three years from the petition date and look forward. Any subsequent return due date (including extensions) that can be “seen” as one looks “into the future” will mean that the taxes associated with that tax year are nondischargeable. Moreover, it is the first petition date and not any conversion date that constitutes the measuring date. Under § 507(a)(8), the three-year period is suspended if the automatic stay is in effect. Thus, a debtor cannot hide in a chapter 13 case for the purpose of “running out” the three year clock. Once the stay is no longer in effect, the clock begins to run again at the place at which it last stopped plus an additional ninety days. A practitioner should order the tax history (MFTRA-X) of her client to ascertain when returns were due, including extensions filed. One can request that information through calling the Tax Practitioner Hotline at 866-860-4259 or by ordering on-line through the E-Services for Tax Professionals Portal.

Example 11:

Taxpayer files a bankruptcy petition under chapter 7 May 1, 2012. Assume Taxpayer is a calendar year cash basis taxpayer. Thus, a tax return associated with taxes for Tax Year 20XX must be filed as of 15 April of 20XX + 1 (or 15 October 20XX + 1 if an extension is timely filed). What taxes would constitute priority claims under section 507(a)(8)(A)(i)?

Answer:

¹⁶⁸ 11 USC § 523(a)(1)(A).

¹⁶⁹ The third priority as set forth in § 507(a)(3) of the Bankruptcy Code is “unsecured claims allowed under § 502(f) of this title.” Under § 502(f), an *involuntary gap* claim is one which arises in the ordinary course of a debtor’s business after the filing of an involuntary petition against the debtor but before either the appointment of a trustee or the entry of an order for relief. An involuntary gap claim is allowed “the same as if such claim had arisen before the date of the filing of the petition.” The involuntary gap claim is the creature of the involuntary bankruptcy case. Recall that the filing of an involuntary petition against the debtor does not operate as an order for relief under the Bankruptcy Code. This priority speaks directly to the time delay made possible by segregating the order for relief from the filing of the petition.

¹⁷⁰ An eighth priority is allowed by § 507(a)(8)(A)(i) of the Bankruptcy Code for unsecured federal tax liens (“unsecured claims of governmental units”) to the extent that such claims are for income or gross receipts taxes incurred before the filing of the bankruptcy petition for which the due date of the tax return (including any extension) occurred within three years before the date the bankruptcy petition was filed or for which the due date of the return (including any extensions) occurred after the filing of the petition. As indicated, the due date of the return, and not the date when the taxes are assessed, determines the priority.

<u>Year</u>	<u>Priority</u>	<u>Prepetition Claim</u>
2012	No	No
2011	Yes	Yes
2010	Yes	Yes
2009	Yes	Yes
2008	No (unless extension)	Yes (status?)

3. Income or gross receipts taxes assessed within 240 days from the filing of the bankruptcy petition.¹⁷¹ This will require the practitioner to obtain evidence of the assessment date, if any. For federal taxes, one can obtain a proof of assessment by requesting a Form 23-C Assessment Certificate, the MFTRA-X tax history, the Form 4340 Certificate of Assessments and Payments, or by looking for transaction codes 150, 290, or 300 (and a few others) from the Account Transcript.
4. Income or gross receipts taxes still assessable under applicable law at the time the bankruptcy petition is filed.¹⁷² These taxes generally include those years that are still under audit risk, tax issues pending in the Tax Court, and taxes associated with a Form 872-A Consent to Extend Time for Assessment (open ended).
5. Recent property taxes assessed prepetition and last due without penalty within one year of the filing.¹⁷³
6. Trust fund taxes incurred at any time, including the *employee's share* of payroll taxes that an employer is required to withhold and, in many states, sales tax.¹⁷⁴
7. The *employer's share* of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition to the extent the return for such taxes was last due (including any extensions of time) within

¹⁷¹Also included are income and gross receipts taxes assessed at any time within 240 days before the date the bankruptcy petition was filed. The 240-day period is extended for the period of time an offer of compromise is considered by the IRS after submission by the taxpayer, plus 30 days after such offer is rejected. Under this rule, the date on which the IRS assesses the tax, rather than the date of the return, determines the priority.

¹⁷²Section 507(a)(8)(A)(iii) grants priority to income and gross receipts taxes not assessed before the filing of a bankruptcy petition, but which are still permitted to be assessed under applicable tax laws. Accordingly, a prepetition and unsecured federal tax lien will still receive an eighth priority under this section if the statute of limitations still allows an assessment of the tax liability after the bankruptcy petition is filed, even though such assessment was not made within the 240-day period (plus any extension) prior to the bankruptcy filing.

¹⁷³An unsecured claim of a governmental unit for property taxes assessed before the bankruptcy petition was filed and last payable without penalty within one year before the filing of the petition is given an eighth priority.

¹⁷⁴Taxes required to be collected or withheld and for which the debtor is liable in whatever capacity are given an eighth priority under § 507(a)(8)(C) of the Bankruptcy Code.

three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed.¹⁷⁵

8. Excise taxes related to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition.¹⁷⁶
9. Certain customs duty under § 507(a)(8)(F) of the BC.¹⁷⁷

D. MISCONDUCT TAX CLAIMS

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

1. Tax liabilities relating to a tax return which was not filed.¹⁷⁸ There have been several cases that have struggled with what constitutes a “return” for these purposes. The Bankruptcy Abuse Prevention and Consumer

¹⁷⁵The *employer's* share of employment taxes on wages earned from the debtor and paid *before* the filing of a bankruptcy petition receives an eighth priority under § 507(a)(8)(D) of the Bankruptcy Code, to the extent the return for such taxes was last due (including any extensions of time) within three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed. Older tax claims of this nature are payable as nonpriority general claims. The *employee's* share of employment taxes on wages earned from a debtor and paid before the filing of a bankruptcy petition also receives an eighth priority as a trust fund tax liability without a three-year limitation.

¹⁷⁶Unsecured claims for excise taxes are given an eighth priority under § 507(a)(8)(E) of the Bankruptcy Code. The excise taxes claimed must relate to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition. If a return is due, the three year period is extended if the due date for filing the return was extended. 11 U.S.C. § 507(a)(8)(E). If a return is not required, the tax claim must relate to a transaction which itself occurred within three years prior to the filing of the bankruptcy petition. For purposes of this priority, excise taxes covered include sales taxes, estate and gift taxes, gasoline and special fuel taxes, wagering taxes, and truck taxes.

¹⁷⁷Unsecured claims for customs duty are given an eighth priority under § 507(a)(8)(F) of the Bankruptcy Code. According to the legislative history, this priority covers duties on imports entered for consumption within one year before the filing of the petition, but which are still unliquidated on the petition date; duties covered by an entry liquidated or unliquidated within one year before the petition date; and any duty on merchandise entered for consumption within four years before the petition but not liquidated as of the petition date, if the Secretary of the Treasury or his or her delegate certifies that duties were not liquidated because of possible assessment of antidumping or countervailing duties or fraud penalties.

¹⁷⁸*See, e.g., In re Bergstrom*, 949 F.2nd 341 (10th Cir. 1991), where the United States Court of Appeals for the Tenth Circuit held that the term “filed return” was not broad enough to include a substitute return prepared by the IRS, absent the debtor’s signature thereon; *In re Pruitt*, 107 B.R. 764 (Bankr. D. Wyo. 1989), where the bankruptcy court held that substitute tax returns filed by the Internal Revenue Service when the debtor failed to file such returns for several years did not preclude application of the Bankruptcy Code rendering tax debts nondischargeable for any tax debt with respect to which a return was required and not filed; *In re Brookman*, 114 B.R. 769 (Bankr. M.D. Fla. 1990), where the bankruptcy court held that the debt for unpaid income taxes was nondischargeable because the debtor failed to rebut prima facie evidence that the tax return for the applicable tax year was not filed; *In re Crawford*, 115 B.R. 381 (Bankr. N.D. Ga. 1990), where the bankruptcy court held that a tax obligation for which the debtor did not file a tax return is non-dischargeable even though the Internal Revenue Service filed the return on the debtor’s behalf.

Protection Act of 2005 (BAPCPA)¹⁷⁹ has now defined a return by reference to applicable nonbankruptcy law. Thus, for federal income tax purposes, a return includes a §6020(a) return where a taxpayer signs it, a written stipulation to a judgment, and a final order by a court of competent jurisdiction. However, a SFR or Substitute for Return assessment (code 290 or 300) prepared by the IRS, any return where the *jurat* has been altered or the return is unsigned, or any return filed in the wrong place do not constitute a return for these purposes. May a taxpayer file a return after the Service has prepared an SFR assessment and meet the return requirement? Five circuits have concluded no but there is some emerging authority to the contrary. The Eleventh Circuit, however, rejected the “one-day” late rule embraced by the First, Fifth, and Tenth Circuits in *In re Justice*, No. 15-10273, 2016 WL 1237766 (11th Cir. Mar. 30, 2016). The Eleventh Circuit rejected the per se rule; rather, it focused its attention on whether the facts and circumstances support a finding that the debtor-taxpayer had undertaken an honest and reasonable attempt to comply with the tax laws. However, just because there is an SFR assessment (code 290 or 300) on the transcript does not end the inquiry; a return can be nondischargeable if it was actually filed before the SFR assessment.

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

¹⁷⁹ Pub.L. 109-9, 119 Stat. 23, enacted April 20, 2005.

3. Tax liabilities reported by a fraudulent return¹⁸⁰ or from an attempt by the debtor to willfully evade or avoid any tax.¹⁸¹ Here, the courts have employed the civil and not criminal fraud standards. However, there are several approaches that do diverge in the hard cases. Generally, the government must prove some conduct on the part of the debtor and a requisite state of mind. To satisfy the conduct requirement, courts look to something more than the failure to pay the tax. For example, the recurrence of an understatement of income, inadequate records, asset transfers, false W-4's, no returns filed, barter transaction history, cash business history, and other forms of concealment may be sufficient to meet the conduct test. As for the state of mind requirement, the civil standard usually mirroring the IRC §6672 responsible person standards for the imposition of trust fund liability are sufficient. Thus, an intentional, knowing, and voluntary act is all that is necessary. In a joint return situation, the state of mind of one spouse will not be imputed to the other spouse.

E. TAX PENALTIES

The third category of nondischargeable taxes is set forth in § 523(a)(7).¹⁸² This section provides that tax penalties which are basically punitive in nature are nondischargeable only if the

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

¹⁸¹ 11 U.S.C. § 523(a)(1).

¹⁸² 11 USC § 523(a)(7), which reads as follows:

penalty is computed by reference to a related tax liability which is also nondischargeable. It appears that if the amount of the penalty is not computed by reference to a tax liability, the transaction or event giving rise to the penalty must occur during a three-year period ending on the date of the filing of the bankruptcy petition.¹⁸³

F. TAX CLAIMS IN INDIVIDUAL DEBTOR CHAPTER 11 CASES

With respect to individual debtors in reorganization under chapter 11, section 1141(d)(2) of the BC incorporates by reference the exceptions to discharge set forth in section 523 and discussed above.¹⁸⁴ Section 1141(d)(2) of the BC provides that the confirmation of a chapter 11 plan does not discharge an *individual debtor* from any debt excepted from discharge under section 523.¹⁸⁵

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

1. The plan provides for the liquidation of all or substantially all of the property of the estate
2. The debtor does not engage in business after consummation of the plan
3. The debtor would be denied a discharge under § 727(a) of the BC if the case were a chapter 7 liquidation proceeding.¹⁸⁶

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

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

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

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

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

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

¹⁸⁵11 USC §§ 1141(d)(2) and 523.

¹⁸⁶*Id.* § 1141(d)(3).

Thus, a debtor is not discharged from any debt (including federal taxes) by the confirmation of a plan if the plan is a liquidation plan and if the debtor would be denied a discharge in a chapter 7 liquidation proceeding pursuant to section 727(a) of the BC.¹⁸⁷ Under section 727(a)(1), only an individual, and not a corporation or a partnership, may obtain a discharge.¹⁸⁸

G. TAX CLAIMS IN CHAPTER 13 CASES

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

1. Debts with the final payment falling due after the final payment under the plan is due as set forth in section 1322(b)(5), that is, certain long-term debt;¹⁸⁹
2. Debts in the form of trust fund taxes; nonfiler taxes; fraudulent taxes or taxes arising from a willful intent to evade; debts incurred under false pretenses; unlisted debt; debts from fraud, etc., when in a fiduciary capacity; domestic support obligations; certain student loans that do not pose an undue hardship to the debtor; debts for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft while intoxicated;
3. Debts for restitution included in a sentence on the debtor's conviction of a crime;¹⁹⁰ and
4. Debts for restitution or damages awarded in a civil action against the debtor as a result of willful or malicious injury by the debtors that caused personal injury to an individual or the death of an individual.

¹⁸⁷S Rep No 989, 95th Cong, 2d Sess 129 (1978).

¹⁸⁸11 U.S.C. § 727(a)(1).

¹⁸⁹11 U.S.C. § 1328(a)(1).

¹⁹⁰11 U.S.C. § 1328(a).

H. DISCHARGE PROCEDURES

An action to except a debt from discharge under section 523 is an adversary proceeding under Part VII of the Bankruptcy Rules. It is commenced by the service of a summons and complaint in accordance with Bankr. R. 4. The Federal Rules of Civil Procedure (“FRCivP”) generally apply to adversary proceedings through Part VII of the Bankruptcy Rules, although several Bankruptcy Rules have non-FRCivP provisions.

The burden of proof to assert that the debt is non-dischargeable under section 523(a) falls squarely on the shoulders of the creditor asserting the exception and not necessarily the plaintiff for reasons soon to become apparent. Unlike many grounds for an exception to discharge that must be brought by the applicable bar date in a bankruptcy case, tax claims that may survive the discharge can be asserted against the individual debtor *in personam* well after the bar date has run or even past the closing of the bankruptcy case. Thus, it may be beneficial for the debtor to commence an adversary proceeding against the relevant taxing authority for a determination of whether the tax claim is dischargeable while the bankruptcy case is pending. If that be the case, the taxing authority still has the burden to prove that the tax claim is nondischargeable. Although there is some authority to allow re-opening of a bankruptcy case that has been closed under section 350, this is simply too thin a reed to rest such an important determination. Thus, a bankruptcy practitioner should carefully consider the tactical and strategic advantages to the commencement of an adversary proceeding where the taxing authority has failed to do so.

X. CONCLUSION

Individuals seek bankruptcy relief because they want the benefits of discharge. However, not all claims are subject to discharge even where the debtor has conducted his or her affairs honestly and with integrity. The BC mandates that certain tax claims survive the debtor's bankruptcy case. These tax claims may be grouped in two broad categories: (1) those claims that Congress has determined must be paid as a matter of public policy regardless of debtor culpability; and (2) those claims that arise from debtor misconduct. Notwithstanding the curtailment of the discharge of taxes, many taxes are subject to discharge in an individual debtor chapter 7, chapter 11, or chapter 13 case. Moreover, since enactment of BAPCPA in 2005, the advantages to a chapter 13 bankruptcy case largely no longer exist. This is quite odd when a primary objective of BAPCPA was the encouragement of debtors to seek relief under chapter 13 instead of chapter 7.

The cross-disciplinary practice of bankruptcy law and tax law brings with it a host of challenging substantive and procedural issues. This practice cuts across federal, state, and local bodies of law. It requires you do become comfortable with working with the IRS and its maze of formal and informal procedures. Daunting yes, but fabulously rewarding. A commitment to understanding this intersection of the law will make you a better bankruptcy practitioner and arm you with the tools necessary to address your client's needs in a robust manner.