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Article

Abandonments in Bankruptcy: Unifying Competing Tax and Bankruptcy Policies

Michelle Arnpol Cecil[†]

INTRODUCTION

On September 11, 2001, terrorists attacked the World Trade Center and the Pentagon, resulting in the largest loss of American lives in one day on United States soil.¹ Measuring the psychological impact of the attacks on the United States and its citizens is likely to prove impossible; however, measuring the economic impact of the attacks is not. Within six weeks of the attacks, the aviation industry alone announced layoffs of more than 158,000 workers.² Continental Airlines and others predicted that they would be forced to file for bankruptcy protection if the government did not step in to bail out the airline industry in the wake of the disaster.³ In the weeks and months after the attacks, evi-

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1. See, e.g., David S. Cloud & Neil King, *Death Toll, Source of Devastating Attacks Remain Unclear; U.S. Vows Retaliation as Attention Focuses on bin Laden*, WALL ST. J., Sept. 12, 2001, at A1.

2. See, e.g., MSNBC Research, *Air Transportation-Related Layoffs* (Oct. 31, 2001) (on file with author) (establishing that 158,170 workers in the airline and plane manufacturing industries had been laid off because of the September 11th attacks as of October 31, 2001); see also J. Lynn Lunsford & Andy Pasztor, *Boeing May Cut as Many as 30,000 Workers*, WALL ST. J., Sept. 19, 2001, at A3 (“Boeing Co., in the single-largest employment cutback so far stemming from last week’s terrorist attacks, said it may be forced to dismiss by the end of next year as many as 30,000 people, or nearly 30% of its commercial-aircraft workers.”).

3. Laurence Zuckerman, *Airlines, in Search of Relief, Warn of Bankruptcy*,

dence of their crippling effect on the United States economy was observed nationwide.⁴

One significant, albeit not widely reported, outcome of this national tragedy is its crushing impact on the country's national bankruptcy system. Several large businesses, including Polaroid, Bethlehem Steel, and Regal Cinemas, sought protection under chapter 11 of the Bankruptcy Code⁵ within two months of the September 11th disaster,⁶ and experts predict the massive increase in both consumer and business bankruptcy filings to con-

N.Y. TIMES, Sept. 15, 2001, at A1 (“[M]ounting losses stemming from this week’s terrorist attacks could force most of the country’s major carriers into bankruptcy.”); see also Micheline Maynard, *Airlines’ Bad Year Is Suddenly Looking Much, Much Worse*, N.Y. TIMES, Sept. 16, 2001, at C6; Scott McCartney et al., *Frightened Workers and Investors Buffet Airlines*, WALL ST. J., Sept. 18, 2001, at A3; Robert J. Samuelson, *Economic Shockwaves*, NEWSWEEK, Sept. 24, 2001, at 54, 54; Allan Sloan, *Pork Barrel or a Kick-Start?*, NEWSWEEK, Oct. 15, 2001, at 65, 65–66.

4. For example, Vanguard Airlines and U.S. Airways filed for chapter 11 bankruptcy protection within a two-week period in late July and early August of 2002, citing the drop-off in consumer demand for air travel in the wake of the September 11th attacks as one of the precipitating factors in their decision to file for bankruptcy. Chris Isidore, *US Air to Cut Flights, Staff*, CNN, at <http://www.cnn.com/2002/BUSINESS/08/23/usair/index.html> (Aug. 23, 2002) (discussing how US Airways, which filed for bankruptcy protection on August 10, 2002, “was hit particularly hard by the Sept. 11 terrorist attack as its main hub at Reagan National Airport in Washington, D.C., remained shut for weeks longer than other airports due to security concerns”); John W. Schoen, *More Airlines on Path to Bankruptcy?*, MSNBC, at <http://www.msnbc.msn.com/id/3073074> (Aug. 12, 2002) (“Sept. 11 hit U.S. Airways harder than most of its rivals. While most other airlines were up and running again within a week, U.S. Airways suffered a prolonged closure of Washington’s Reagan National Airport and the slowdown in travel at its eastern hubs.”); *Vanguard Airlines to File Chapter 11*, CNN, at <http://www.cnn.com/2002/TRAVEL/NEWS/07/30/vanguard.bankruptcy/index.html> (July 30, 2002) (noting that Scott Dickson, chairman, CEO, and president of Vanguard, “partially blamed the post-September 11 business climate for the airline’s demise”).

5. Unless otherwise stated, references in this Article to the “Bankruptcy Code” are to the Bankruptcy Code of 1978, as amended, 11 U.S.C. §§ 1–1330 (2000).

6. *Bethlehem Steel Files Chapter 11*, BANKR. CT. DECISIONS, Nov. 13, 2001, at A6; Adam Geller, *Pensions Fall as Bankruptcies Rise*, KAN. CITY STAR, Nov. 19, 2001, at B6 (discussing the bankruptcy filings of Polaroid and Bethlehem Steel); *Regal Cinemas, Theater Operator, Files for Bankruptcy*, N.Y. TIMES, Oct. 13, 2001, at C4; *Steelmaker Files for Chapter 11 Bankruptcy*, KAN. CITY STAR, Oct. 16, 2001, at D8. In addition, International Total Services, Inc., one of the largest airport security companies in the United States, was forced to file for bankruptcy on October 13, 2001, in the wake of the September 11th terrorist attacks. *Large Airport Security Company Files Chapter 11*, BANKR. CT. DECISIONS, Oct. 2, 2001, at A3.

tinue as the economy slows and consumer confidence wanes.⁷ In fact, in 2002 consumer bankruptcy filings reached an historic high of 1.5 million new cases, surpassing 2001's record filings by nearly eight percent.⁸ As the number of bankruptcy cases rises, the burden on the already overworked bankruptcy courts will continue to mount.⁹ In this situation it is imperative that the bankruptcy system operate effectively, which is impossible with so many bankruptcy issues left unanswered. This Article attempts to resolve one such issue: the tax consequences of property abandonments by the bankruptcy trustee.

When a debtor files a bankruptcy petition seeking protection under the Bankruptcy Code, an estate is created automatically.¹⁰ All legal and equitable interests of the debtor as of the commencement of the case become property of the bankruptcy estate by operation of law.¹¹ A trustee is appointed to administer the bankruptcy estate, primarily for the benefit of unsecured creditors.¹² The trustee must determine whether each item of property in the bankruptcy estate has value to the estate. Property that is

7. Maureen Milford, *Attacks Likely to Spur Chapter 11s*, NAT'L L.J., Oct. 1, 2001, at A6 ("Speculation is rampant that certain companies that were wavering before the attack—companies in the airline, travel, retail, and hotel and hospitality industries—will seek to reorganize in bankruptcy."); Paul Wenske, *Bankruptcies Surge Amid Debt, Lost Jobs*, KAN. CITY STAR, Dec. 5, 2001, at C1 ("Soaring bankruptcy filings locally and across the country are providing more signs that the nation's economy is staggering under high consumer debt and rising layoffs, bankruptcy experts say."); see also Catherine E. Bauer, *Can These Laid-Off Workers Avoid Bankruptcy?*, BANKR. CT. DECISIONS, Oct. 16, 2001, at A7 (discussing the financial and mental shock many laid-off workers experience, as well as the ongoing vulnerability to bankruptcy of many consumers); Laurence Zuckerman, *Some Think United Is Heading for Bankruptcy*, KAN. CITY STAR, Feb. 10, 2002, at F13. In fact, the Administrative Office of the Courts saw a record number of bankruptcy filings during the twelve-month period ending on March 31, 2002. Jim Wannamaker, *Record Bankruptcy Filings*, NABTALK, Fall 2002, at 35, 35.

8. See, e.g., Press Release, Administrative Office of the U.S. Courts, Record Breaking Bankruptcy Filings Reported in Calendar Year 2002 (Feb. 14, 2003), http://www.uscourts.gov/Press_Releases/cy02.pdf.

9. According to the Administrative Office of the Courts, bankruptcy filings "per authorized judgeship have risen from 2,883 per judgeship in the 12 months ending March 31, 1993, to 4,644 in March 2002. No new bankruptcy judgeships . . . have been created since 1992 and, in fact, two of the 326 judgeships authorized in 1992 have expired." Wannamaker, *supra* note 7, at 35.

10. 11 U.S.C. § 541(a) (2000).

11. *Id.*; see also *infra* notes 54–56 and accompanying text.

12. See 1 DAVID G. EPSTEIN ET AL., BANKRUPTCY § 1-4, at 8, § 1-7, at 11 (1992). Generally, it is the duty of the United States trustee to appoint the bankruptcy trustee, but sometimes a committee of creditors can appoint the trustee. *Id.* § 1-4, at 8, § 1-7, at 11.

fully encumbered by liens, for example, will be of no value to the estate. In such a case, the trustee has the power under the Bankruptcy Code to abandon the property back to the debtor or to another party with a possessory interest in that property.¹³ For example, if the debtor owns a factory with a fair market value of \$450,000 that is encumbered by a nonrecourse mortgage of \$500,000, the factory has no value to the debtor's unsecured creditors; therefore, the trustee will abandon the factory either to the debtor or to the party holding the \$500,000 mortgage on it (so long as the mortgage holder has a possessory interest in the factory at the time of the abandonment).

The issue that has perplexed the courts is whether the trustee's abandonment of the factory should be a taxable event to the bankruptcy estate.¹⁴ For example, if the factory has a basis for tax purposes of \$200,000, should the estate be liable for income taxes owed on the \$300,000 gain triggered upon the factory's abandonment, or should the abandonment instead be viewed as a nontaxable transfer, so that the debtor becomes liable for the income taxes due on the \$300,000 gain when she later sells or disposes of the factory?¹⁵ This issue is governed by both the Bankruptcy Code and the Tax Code.¹⁶ Although each statute offers some guidance as to whether an abandonment is a taxable transfer, neither statute fully resolves this important issue.¹⁷ Courts have grappled

13. 11 U.S.C. § 554 (2000). For a more comprehensive discussion of the trustee's abandonment powers, see *infra* notes 30–48 and accompanying text.

14. The two leading cases in this area are *In re A.J. Lane & Co.*, 133 B.R. 264 (Bankr. D. Mass. 1991), and *Samore v. Olson (In re Olson)*, 930 F.2d 6 (8th Cir. 1991) (per curiam). In *A.J. Lane*, the court held that the trustee's abandonment of an asset to the debtor resulted in taxable gain to the bankruptcy estate. *A.J. Lane*, 133 B.R. at 269–70. Conversely, the court in *Olson* held that an abandonment did not constitute a taxable transfer and, therefore, resulted in no gain to the bankruptcy estate. *Olson*, 930 F.2d at 8. Part II of this Article, *infra*, discusses these cases and their progeny in greater detail.

15. For tax purposes, taxable gain is calculated by subtracting an asset's adjusted basis from the amount realized upon its sale or other disposition. I.R.C. § 1001(a) (2000); see also *infra* note 49 and accompanying text. In this example, the factory's adjusted basis is \$200,000. While the amount realized upon an asset's disposition is often its fair market value on the date it is sold or otherwise disposed of, the Supreme Court has held that if an asset is encumbered by a nonrecourse liability in excess of the property's fair market value, the amount realized upon the asset's disposition is equal to the amount of the liability relieved, here \$500,000. See *Comm'r v. Tufts*, 461 U.S. 300, 313 (1983). Thus, the taxable gain upon the sale or other disposition of the factory will be \$300,000 (\$500,000 amount realized less \$200,000 adjusted basis).

16. 11 U.S.C. § 554; I.R.C. § 1398 (2000).

17. For a comprehensive discussion of the Bankruptcy and Tax Code provisions governing abandonments, see *infra* notes 30–48, 54–62 and accompanying

with the issue with no greater success.¹⁸

Although the abandonment issue might sound inconsequential in comparison to nationally debated bankruptcy issues such as whether a system of means testing should be adopted to screen debtors for chapter 7 eligibility¹⁹ and whether credit card debts should receive preferential treatment in bankruptcy,²⁰ the taxation of property abandonments is an issue that lies at the very heart of the dual policy justifications of bankruptcy: ensuring the debtor's fresh start²¹ while providing for a fair and equitable distribution of assets to creditors.²² A recent empirical study conducted by the Commercial Law League of America estimated that, over a four-year testing period, the uncertainty over the tax consequences of property abandonments resulted in nearly \$340,000,000 in assets not being distributed to unsecured creditors.²³ Thus, according to the study, unsecured creditors "are be-

text.

18. See *infra* notes 63–145 and accompanying text.

19. See, e.g., Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. 333, 107th Cong. § 102 (2001); H.R. REP. NO. 107-3, pt. 1, at 461–62 (2001); S. REP. NO. 106-49, at 4–9 (1999); H.R. REP. NO. 106-123, pt. 1, at 388–90 (1999); S. REP. NO. 105-253, at 26 (1998); H.R. REP. NO. 105-540, at 234–40 (1998); see also Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559, 615–20 (2001); Todd J. Zywicki, *Bankruptcy Law as Social Legislation*, 5 TEX. REV. L. & POL. 393, 427–29 (2001); Rocco I. Debitetto, Comment, *Bankruptcy Reform in Light of Increased Consumer Filings: Means-Testing Employed to Prevent Long-Run Economic Impacts on Consumers and to Cure Debtor Abuse Under the Current Bankruptcy Code*, 69 U. CIN. L. REV. 641 (2001).

20. See, e.g., H.R. 333, § 314; *Bankruptcy Reform Act of 1998; Responsible Borrower Protection Act; and Consumer Lenders and Borrowers Bankruptcy Accountability Act of 1998—Part III: Hearing on H.R. 3150, H.R. 2500, and H.R. 3146 Before the Subcomm. on Commercial and Admin. Law of the House Comm. on the Judiciary*, 105th Cong. 146–47 (1998) (statement of Jeffrey W. Morris, Professor of Law, University of Dayton School of Law, Representing the National Bankruptcy Conference); 146 CONG. REC. S11625-28 (daily ed. Dec. 6, 2000) (statement of Sen. Durbin); Margaret Howard, *Shifting Risk and Fixing Blame: The Vexing Problem of Credit Card Obligations in Bankruptcy*, 75 AM. BANKR. L.J. 63 (2001); Veryl V. Miles, *Fairness, Responsibility, and Efficiency in the Bankruptcy Discharge: Are the Commission's Recommendations Enough?*, 102 DICK. L. REV. 795 (1998).

21. See, e.g., H.R. REP. NO. 95-595, at 125 (1977), reprinted in 1978 U.S.C.A.N. 5963, 6086 (noting that the fresh start allows debtors "to get out from under the debilitating effects of too much debt" and that "[t]he two most important aspects of the fresh start available under the Bankruptcy laws are the provision of adequate property for a return to normal life, and the discharge, with the release from creditor collection attempts").

22. See, e.g., *Burlingham v. Crouse*, 228 U.S. 459, 473 (1913); *IRS v. Luongo (In re Luongo)*, 259 F.3d 323, 330 (5th Cir. 2001).

23. See Max G. Moses, *Proposal for Capital Gains Taxes and Bankruptcy*

ing deprived of a source of funds from which they could recoup some portion of the billions lost each year to bankrupt debtors."²⁴ A similar study revealed that in over ninety-seven percent of the bankruptcy proceedings involving secured claims that were included in its survey, at least some collateral was abandoned by the trustee.²⁵

This Article not only resolves the issue of whether the trustee's abandonment of property is a taxable transfer from a strict statutory construction standpoint, but it also attempts to provide a more comprehensive solution to the broader issue of who should bear the burden of the tax imposed on the gain inherent in an asset as of the commencement of a bankruptcy proceeding. By way of background, Part I provides the statutory framework necessary to understand the abandonment issue, examining the relevant provisions of both the Bankruptcy and Tax Codes. In Part II, the Article addresses the conflicting case law on the issue of whether an abandonment is a taxable event to the bankruptcy estate. Because a proper resolution of this issue must necessarily harmonize bankruptcy and tax policy, Part III examines these competing policies. Part IV of the Article discusses four other significant works that have studied the bankruptcy abandonment issue in the past. Finally, Part V offers a comprehensive resolution of the issue, providing a three-pronged approach to the taxation of property abandonments in a debtor's bankruptcy proceeding. First, it suggests that the debtor should bear the burden of

Cases, 102 COM. L.J. 219, 219-20 (1997) (proposing an amendment to the Internal Revenue Code "to provide that the trustee in bankruptcy receives a 'stepped up basis' in property similar to that currently enjoyed by heirs of decedent's estates"). For a more comprehensive discussion of the Commercial Law League's study, see *infra* notes 168-76 and accompanying text.

24. Commercial Law League of Am., *Impact of Potential Capital Gain Taxes on the Sale of Assets in Bankruptcy Cases*, COM. L. BULL., May-June 1996, at 21, 21.

25. Michael J. Herbert & Domenic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed During 1984-1987*, 22 U. RICH. L. REV. 303, 312 (1988). The authors clarified the impact of abandonments on bankruptcy proceedings by stating:

Three of the most striking statistics in this study are the stated value of abandoned collateral as a percentage of the total collateral (96.6%), the stated value of abandoned collateral as a percentage of the stated value of all assets available for distribution (80.9%) and the stated value of all abandoned and distributed collateral as a percentage of the stated value of all assets available for distribution (83.8%). As large as these percentages are, there is some possibility that they are actually *understated* because of unreported abandonments.

Id. (footnotes omitted).

the tax on the gain inherent in an asset as of the commencement of the case because it was the debtor who enjoyed the benefits of the asset's appreciation before bankruptcy. Second, the Article recognizes that the debtor does not have the cash available to pay this tax, and thus proposes that the gain should be treated as discharge of indebtedness income.²⁶ This tax treatment allows the debtor to postpone paying the tax until he disposes of the asset, either through sale or foreclosure. Finally, the proposal allows the debtor to retain his tax attributes, such as net operating losses,²⁷ to absorb the tax liability arising upon the debtor's disposition of the asset. The Article concludes that this three-pronged solution to the bankruptcy abandonment issue harmonizes competing bankruptcy and tax policies, thus bringing the bankruptcy system one step closer to operating more efficiently and effectively.

I. TAXATION OF ABANDONMENTS: A STATUTORY FRAMEWORK

Although both the Bankruptcy Code and the Tax Code are extraordinarily detailed and complex, little attention has been paid to the intricate interplay between these two massive statutes.²⁸ Two years after Congress enacted the Bankruptcy Code in 1978, it attempted to resolve many of the thorny income tax issues raised in corporate and individual bankruptcy proceedings by passing the Bankruptcy Tax Act of 1980.²⁹ While bankruptcy

26. The concept of discharge of indebtedness income is discussed more fully *infra* notes 243–58 and accompanying text.

27. For a comprehensive examination of tax attributes, see *infra* notes 268–78 and accompanying text.

28. See, e.g., Jack F. Williams, *Rethinking Bankruptcy and Tax Policy*, 3 AM. BANKR. INST. L. REV. 153, 154 (1995) (“[T]he interface between bankruptcy and tax presents a plethora of issues, many of which are ignored in traditional bankruptcy literature.”).

29. Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389 (codified as amended in scattered sections of 26 U.S.C.). The history of the enactment of the Bankruptcy Tax Act is quite interesting. In the early 1970s Congress appointed a special commission to review the entire structure of the bankruptcy laws, which dated back to 1898. See Paul H. Asofsky, *Toward a Bankruptcy Tax Act of 1993*, 51 N.Y.U. INST. ON FED. TAX’N § 13.02, at 13-4 (1993). One of the Commission’s consultants was William T. Plumb, Jr., arguably the most influential bankruptcy tax scholar of the twentieth century. *Id.* Although the Commission’s report was quite comprehensive and contained a full chapter addressing topics related to bankruptcy taxation, jurisdictional acrimony between the House Judiciary Committee, responsible for the bankruptcy laws of the United States, and the House Ways and Means Committee, responsible for federal taxation matters, threatened to undermine the entire bankruptcy overhaul

practitioners and scholars applauded the Bankruptcy Tax Act as the most sweeping and comprehensive attempt by Congress in history to harmonize bankruptcy and tax policy, Congress has done little since that time to resolve the myriad bankruptcy taxation issues that have arisen under the modern Bankruptcy Code, including the taxation of property abandonments by the bankruptcy trustee. This section will establish the statutory framework necessary to understand this challenging issue. It first examines section 554 of the Bankruptcy Code, which governs property abandonments in bankruptcy. It then explores section 1398 of the Tax Code, which permits transfers into and out of an individual's bankruptcy estate to be nontaxable under limited circumstances.

A. THE BANKRUPTCY CODE: SECTION 554

Under the Bankruptcy Code, the trustee is permitted to abandon any property that is of inconsequential value to the bankruptcy estate, or is otherwise burdensome to the estate.³⁰ The primary purpose for permitting abandonment is to "maximize the estate for the benefit of [the debtor's] creditors."³¹ The property can be abandoned to any party that has a possessory interest in the property, including the debtor or a secured creditor.³²

process. *See id.* § 13.02, at 13-4 to 13-6.

The sponsors of the bankruptcy bill responded to this turf war by removing all references in the bill to federal taxation matters. *Id.* § 13.02, at 13-6. Thus, when Congress enacted a sweeping overhaul of the bankruptcy system in the Bankruptcy Code in 1978, the bill contained references only to state and local income tax issues. *Id.* All federal tax matters were introduced in a separate bill, which was given lengthy consideration by the House and Senate committees responsible for both tax and bankruptcy matters. *Id.* § 13.02, at 13-6 to 13-7. After extensive testimony and debate, Congress passed the Bankruptcy Tax Act of 1980 on December 13, 1980. *Id.* § 13.02, at 13-11. For a complete history of the hearings and debate leading up to the passage of the Act, see *id.* § 13.02, at 13-4 to 13-14.

30. 11 U.S.C. § 554(a) (2000); see also S. REP. NO. 95-989, at 92 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5878. For a history of the judicial development of the concept of abandonment prior to the enactment of the Bankruptcy Code, see C. RICHARD MCQUEEN & JACK F. WILLIAMS, TAX ASPECTS OF BANKRUPTCY LAW AND PRACTICE § 24:6 (3d ed. 1997).

31. Terjen v. Santoro (*In re Terjen*), 154 B.R. 456, 458 (E.D. Va. 1993), *aff'd*, 30 F.3d 131 (4th Cir. 1994) (unpublished table decision). In addition, the abandonment provision serves to "provide for the orderly and efficient reduction of the bankrupt's debts." *In re Nevin*, 135 B.R. 652, 654 (Bankr. D. Haw. 1991) (mem.) (quoting *In re Olson*, 121 B.R. 346, 348 (N.D. Iowa 1990), *aff'd*, 930 F.2d 6 (8th Cir. 1991) (per curiam)).

32. S. REP. NO. 95-989, at 92; H.R. REP. NO. 95-595, at 378 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6333. A possessory interest includes the "right to

The trustee must notify all creditors and creditors' committees, as well as the United States trustee, of the proposed abandonment.³³ If the trustee fails to seek abandonment of property in a situation in which the property is burdensome or of inconsequential value to the estate, another party in interest may request that the bankruptcy court order the trustee to do so.³⁴ Once made, an abandonment is irrevocable, even if the property subsequently increases in value or was improperly undervalued at the time the trustee abandoned the property.³⁵ A proper abandonment will relate back to the commencement of the case, and title to the abandoned property will revert in the debtor as though the estate never owned it.³⁶ The bankruptcy court, however, retains jurisdiction over the abandoned property so that it can decide bank-

control property, including the right to exclude others, by a person who is not necessarily the owner" as well as a "right to the exclusive use and possession of property." BLACK'S LAW DICTIONARY 1185 (7th ed. 1999). Several courts have determined that section 554, together with its legislative history, requires the trustee to abandon property to the party that holds the superior possessory interest in it. *See, e.g., In re Popp*, 166 B.R. 697, 700 (Bankr. D. Neb. 1993) (mem.); *Riggs Nat'l Bank of Wash., D.C. v. Perry (In re Perry)*, 29 B.R. 787, 793 (D. Md. 1983), *aff'd*, 729 F.2d 982 (4th Cir. 1984); *In re Cruseturner*, 8 B.R. 581, 591 (Bankr. D. Utah 1981).

33. *See* FED. R. BANKR. P. 6007(a); *see also* *Sierra Switchboard Co. v. Westinghouse Elec. Corp.*, 789 F.2d 705, 709-10 (9th Cir. 1986) (concluding that a trustee's abandonment is ineffective without proper notice). If a party in interest objects to the trustee's proposed abandonment, the bankruptcy court will hold a hearing to determine whether abandonment is appropriate. FED. R. BANKR. P. 6007(a). In a case in which no objections are raised to the proposed abandonment, it can take place without a hearing and court order. *See In re Trim-X, Inc.*, 695 F.2d 296, 300 (7th Cir. 1982); *In re Wilson*, 94 B.R. 886, 888 (Bankr. E.D. Va. 1989); *Hickman v. First State Bank of Cordele (In re Motley)*, 10 B.R. 141, 146 (Bankr. M.D. Ga. 1981).

34. 11 U.S.C. § 554(b) (2000); *see also* FED. R. BANKR. P. 6007(b). If a party in interest files a motion asking that the court compel the trustee to abandon estate property, the court must hold a hearing on the motion. *See* FED. R. BANKR. P. 6007(a). The trustee's act of filing a "no-asset" report in a chapter 7 case does not rise to the level of an abandonment under the Bankruptcy Code. *See Figlio v. Am. Mgmt. Servs., Inc. (In re Figlio)*, 193 B.R. 420, 423 n.2 (Bankr. D.N.J. 1996); David S. Kennedy & R. Spencer Clift, III, *The Mere Filing of the Chapter 7 Trustee's "No-Asset" Report Does Not Constitute an "Abandonment" of Estate Property Under Section 554(a) of the Bankruptcy Code and Federal Rule of Bankruptcy Procedure 6007*, 11 J. BANKR. L. & PRAC. 347, 352-53 (2002).

35. *See In re Brio Ref., Inc.*, 86 B.R. 487, 490 (N.D. Tex. 1988) (mem.); *Wallace v. Enriquez (In re Enriquez)*, 22 B.R. 934, 935-36 (Bankr. D. Neb. 1982) (mem.); *In re Sutton*, 10 B.R. 737, 739-40 (Bankr. E.D. Va. 1981); *see also* 15 MYRON M. SHEINFELD ET AL., *COLLIER ON BANKRUPTCY* ¶ TX2.03[1][b][iv] (Alan N. Resnick & Henry J. Sommer eds., 15th ed., rev. 2003).

36. *Nevin*, 135 B.R. at 653 (citing *Mason v. Comm'r*, 68 T.C. 163 (1977), *aff'd*, 646 F.2d 1309 (9th Cir. 1980) (per curiam)).

ruptcy-related issues, such as violations of the automatic stay with respect to the abandoned property and the dischargeability of debts encumbering the property.³⁷

The right to abandonment is not absolute, however.³⁸ For example, in one case the trustee attempted to abandon a toxic waste site as burdensome to the bankruptcy estate.³⁹ The Supreme Court refused to permit the proposed abandonment because it would have violated state laws enacted to protect public health and safety.⁴⁰ Accordingly, the Court held that restrictions on the trustee's abandonment power can be created if such restrictions protect important federal and state interests.⁴¹

The classic scenario in which the bankruptcy trustee will seek to abandon property as burdensome or of inconsequential value to the estate is when the property is encumbered by a liability in excess of its fair market value.⁴² For example, assume that a debtor owns a car worth \$10,000 that is subject to a valid lien of \$15,000. If the debtor files for chapter 7 bankruptcy protection, the car will become property of the bankruptcy estate by operation of law.⁴³ Because there is no value in the car for unsecured creditors, however, the trustee will almost certainly seek to abandon the property pursuant to section 554 of the Bankruptcy Code.⁴⁴ Moreover, even if the lien in the foregoing example were

37. See, e.g., *Dunmore v. United States* (*In re Dunmore*), 254 B.R. 761, 763 (Bankr. N.D. Cal. 2000) (mem.); *In re Shields*, 24 B.R. 219, 220 (Bankr. S.D. Ohio 1982); *Bennett v. Commercial Credit Plan* (*In re Bennett*), 13 B.R. 643, 645 (Bankr. W.D. Mich. 1981); see also Todd Johnson, Note, *Two Codes Collide: Is Abandoning Property by a Chapter 7 Trustee a Tax Recognition Event for the Bankruptcy Estate?*, 14 J. CORP. L. 687, 711 (1989).

38. *In re Pilz Compact Disc, Inc.*, 229 B.R. 630, 641 (Bankr. E.D. Pa. 1999) (mem.).

39. *Midlantic Nat'l Bank v. N.J. Dep't of Env'tl. Prot.*, 474 U.S. 494, 497-98 (1986).

40. *Id.* at 507. For a comprehensive discussion of this public policy exception to abandonments carved out by *Midlantic*, see Joseph S. Maniscalco, Note, *At the Crossroads of Environmental Laws and the Bankruptcy Code: Abandonment and Trustee Personal Liability*, 23 HOFSTRA L. REV. 879, 895-903 (1995).

41. *Midlantic*, 474 U.S. at 506-07.

42. See, e.g., *In re Burpo*, 148 B.R. 918, 919 (Bankr. W.D. Mo. 1993) (trustee abandoned thirteen tracts of real estate as burdensome to the bankruptcy estate because they were encumbered by mortgage liens in excess of their fair market value).

43. See 11 U.S.C. § 541 (2000).

44. The timing of the tax consequences of the proposed abandonment will differ depending on whether the trustee abandons the car to the debtor or instead to the secured creditor. For a complete discussion of this issue, see *infra* notes 45-53 and accompanying text.

only \$8000, if the debtor were entitled to an automobile exemption of \$2000 or more, as would be the case if the debtor used the federal bankruptcy exemption scheme,⁴⁵ the trustee would again abandon the car as of inconsequential value to the bankruptcy estate because the secured creditor's lien of \$8000, together with the debtor's automobile exemption of \$2000, absorb all of the value in the car, leaving nothing for the unsecured creditors.

One issue that has perplexed courts since the enactment of the Bankruptcy Code in 1978 is whether the trustee can use his power of abandonment to avoid incurring income tax liability on built-in gains inherent in estate property.⁴⁶ For example, assume that a debtor purchases Blackacre for \$10,000 in 1975. In 2001, the debtor, an airplane mechanic, is laid off from her job because of economic distress in the airline industry. At the time of her layoff, Blackacre is worth \$80,000. She borrows \$60,000 from a local bank to make ends meet, using Blackacre as collateral for the loan. Unfortunately, as bills continue to mount with no prospects of employment in sight, the debtor is forced to file for chapter 7 bankruptcy protection in 2002, with Blackacre becoming property of the estate by operation of law.⁴⁷ The trustee attempts to abandon Blackacre as burdensome to the estate, arguing that, if the trustee were to sell the property instead of abandoning it, after the secured creditor's \$60,000 claim is paid, the \$20,000 of remaining equity would be insufficient to pay income taxes on the \$70,000 gain inherent in the property.

Courts that have considered this issue have reached conflicting results, largely because the provisions of the Internal Revenue Code governing the tax consequences of abandonments do not squarely address the issue. Thus, before discussing the conflicting case law on the tax consequences of abandonments in bankruptcy, it is necessary to examine the relevant provisions of the Internal Revenue Code.⁴⁸

B. SECTION 1398 OF THE TAX CODE

It is a fundamental notion of federal income tax law that when a taxpayer sells appreciated property, she realizes a gain

45. 11 U.S.C. § 522(d)(2) (2000).

46. For a comprehensive discussion of the conflicting case law on this issue, see *infra* notes 63–145 and accompanying text.

47. See *infra* notes 55–56 and accompanying text.

48. References to the Internal Revenue Code refer to the Internal Revenue Code of 1986, as amended, unless otherwise noted. This Article will often refer to the Internal Revenue Code as the Tax Code.

for tax purposes equal to the difference between the amount that she realizes on the sale and the adjusted basis of the property transferred.⁴⁹ This realized gain must be recognized, or included in the taxpayer's gross income, in the year of the sale unless a specific provision of the Tax Code permits the taxpayer to defer recognizing the gain until a later time.⁵⁰

If, instead of selling appreciated property, the taxpayer transfers the property to a creditor in satisfaction of a liability, this disposition also constitutes a realization event. Accordingly, the taxpayer must include any built-in gain inherent in the property in gross income in the year of the transfer.⁵¹ Similarly, courts have held that an abandonment of property by a taxpayer triggers the recognition of gain,⁵² as does a foreclosure of property by

49. See I.R.C. § 1001(a) (2000). The amount realized on the sale consists of the amount of cash received, the fair market value of property and services received, and any liabilities paid or otherwise assumed by the transferee on the sale. See *id.* § 1001(b); *Comm'r v. Tufts*, 461 U.S. 300, 312–13 (1983); *Diedrich v. Comm'r*, 457 U.S. 191, 197–99 (1982); *Crane v. Comm'r*, 331 U.S. 1, 14 (1947). The taxpayer's adjusted basis is determined by reference to I.R.C. §§ 1011–1023 (2000). For a more complete discussion of the concepts of amount realized and adjusted basis, see BORIS I. BITTKER ET AL., *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶¶ 29.01–.17 (3d ed. 2002).

50. I.R.C. § 1001(c) (2000). Provisions allowing the taxpayer to defer the recognition of gain are referred to as nonrecognition provisions. See, e.g., *id.* § 453 (governing installment sales); *id.* § 1031 (governing like-kind exchanges).

Similarly, if a taxpayer sells depreciated property, any loss realized on the sale can be recognized, or deducted from the taxpayer's gross income, unless a nonrecognition provision applies. See *id.* § 165. There are, however, several limitations on the deductibility of losses. For example, the Tax Code only permits the deductibility of losses incurred in the taxpayer's trade or business, in a transaction entered into for profit (such as investment losses), and upon the occurrence of a casualty. See *id.* § 165(c). Thus, losses from the sale of personal use property, such as a pleasure boat or the taxpayer's automobile, are not deductible. In addition, losses from the sale of capital assets are deductible only to the extent of the taxpayer's capital gains for the year (plus up to \$3000 of ordinary income in the case of individuals). See *id.* § 1211. Because the issue of the tax consequences of abandonments in bankruptcy arises almost exclusively in the case of appreciated property, this Article will focus on gain rather than loss property. The analysis, however, would be identical in the case of depreciated property, except that any loss triggered by the disposition of loss property in bankruptcy might not be deductible for tax purposes because of the limitations outlined above.

51. See, e.g., *Int'l Freighting Corp. v. Comm'r*, 135 F.2d 310, 313 (2d Cir. 1943).

52. See *Yarbro v. Comm'r*, 737 F.2d 479, 486 (5th Cir. 1984) (holding an abandonment of property by the taxpayer constitutes a taxable exchange); *Middleton v. Comm'r*, 77 T.C. 310, 320–21 (1981), *aff'd*, 693 F.2d 124 (11th Cir. 1982) (per curiam).

a secured creditor.⁵³

When a debtor files for bankruptcy protection under the Bankruptcy Code,⁵⁴ an estate is created by operation of law.⁵⁵ The estate is composed of all of the debtor's pre-petition property, with certain very limited exceptions.⁵⁶ If the bankruptcy trustee sells appreciated property that is part of the estate to satisfy the claims of creditors, the estate must include any built-in gain inherent in the property in gross income under the general rules of taxation outlined above.⁵⁷ Moreover, if the trustee transfers en-

53. Cf. *Helvering v. Hammel*, 311 U.S. 504, 510-11 (1941) (concluding that losses from involuntary sales and voluntary sales are treated equally); see also *Electro-Chem. Engraving Co. v. Comm'r*, 311 U.S. 513, 514 (1941) (same). Indeed, the Supreme Court has held that even a foreclosure on a nonrecourse mortgage results in the recognition of gain by the owner of the property. *Helvering v. Neb. Bridge Supply & Lumber Co.*, 312 U.S. 666, 667 (1941).

54. Although individual debtors generally file for bankruptcy relief under either chapter 7 or chapter 13, the Supreme Court has held that they are also entitled to file a bankruptcy petition under chapter 11 of the Bankruptcy Code, which generally governs corporate reorganizations. *Toibb v. Radloff*, 501 U.S. 157, 166 (1991). Because chapter 11 reorganizations are very time consuming and expensive relative to chapter 7 or chapter 13, however, it is rare for an individual debtor to choose chapter 11 over the other two types of bankruptcy proceedings. See, e.g., H.R. REP. NO. 95-595, at 6 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 5968 ("The procedures of chapter 11 . . . are sufficiently burdensome that their use will only make sense in the business context, and not in the consumer context."). A recent empirical study, however, concluded that individuals owning businesses may be filing chapter 11 petitions in greater numbers than originally anticipated. Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR. L.J. 499, 501 (1999) (finding that individuals, not corporate entities, filed one-quarter of chapter 11 business bankruptcies).

55. 11 U.S.C. § 541 (2000).

56. See *id.* § 541(b), (c)(2).

57. See, e.g., *Waldschmidt v. Comm'r (In re Lambdin)*, 33 B.R. 11, 12-13 (Bankr. M.D. Tenn. 1983) (mem.). The tax paid on the gain will constitute an administrative expense of the bankruptcy estate, and will accordingly be granted a first priority in bankruptcy. *In re Swann*, 149 B.R. 137, 146 (Bankr. D.S.D. 1993) (mem.); S. REP. NO. 95-989, at 66 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5852; see also 11 U.S.C. §§ 503(b)(1)(B), 507(a)(1) (2000). If a tax liability generated by the estate during the pendency of the bankruptcy proceeding is not paid by the estate, such liability does not revert back to the debtor when the estate terminates. 6 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE 2D § 128:12, at 128-15 (1997).

It is important to note that the estate will only be treated as a separate taxable entity in the case of individual debtors filing for bankruptcy protection under chapter 7 or 11 of the Bankruptcy Code. I.R.C. § 1398 (2000). In all other cases, the bankruptcy estate is not treated as a taxable entity separate and apart from the debtor. *Id.* § 1399. Thus, the discussion contained in this section applies primarily in the case of individual debtors filing for chapter 7 bankruptcy relief, as most individual debtors file for bankruptcy protection

cumbered property to a secured creditor in full or partial satisfaction of the creditor's claim, or if the secured creditor forecloses on encumbered property while it is property of the bankruptcy estate, the estate is liable for income tax on any gain inherent in the property at the time of the transfer or foreclosure.⁵⁸

The issue that is currently unresolved is whether the trustee is liable for paying taxes on the gain inherent in appreciated property if the trustee abandons the property to the debtor pursuant to section 554 of the Bankruptcy Code during the administration of the estate.⁵⁹ In other words, is bankruptcy abandonment a realization event for federal income tax purposes?

The Tax Code deals only briefly with the tax consequences of transfers into and out of the bankruptcy estate. Section 1398 of the Tax Code provides that "[a] transfer (other than by sale or exchange) of an asset from the debtor to the estate shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition."⁶⁰ Thus, when a debtor files a bankruptcy petition and his pre-petition property is transferred to the bankruptcy estate by operation of law, the transfer is not treated as a sale or other disposition for income tax purposes; therefore, the debtor realizes no gain or loss as a result of the transfer.

Similarly, the Tax Code provides that "[i]n the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition."⁶¹ Therefore, upon the termination of the estate at the close of the bankruptcy proceeding, any property remaining in the estate that reverts back to the debtor by operation of law will not trigger a realization event; hence, the estate will not be taxed on any gain or loss inherent in estate prop-

under either chapter 7 or chapter 13 rather than chapter 11. See *supra* note 54. Yet even though the tax discussion included in this section currently applies only in the case of individuals seeking chapter 7 or 11 relief, the problem is, in fact, much broader. Accordingly, the solution crafted in Part V of this Article, *infra*, encompasses not only individual debtors, but corporate debtors as well. In addition, the solution is broad enough to cover individual debtors seeking chapter 12 or 13 bankruptcy relief.

58. See, e.g., Jack F. Williams, *The Tax Consequences of Abandonment Under the Bankruptcy Code*, 67 TEMP. L. REV. 13, 40-41 (1994).

59. For a comprehensive discussion of the conflicting case law on this issue, see *infra* notes 63-145 and accompanying text.

60. I.R.C. § 1398(f)(1).

61. *Id.* § 1398(f)(2).

erty at the time of the reversion.⁶² It is unclear, however, whether an abandonment of property by the trustee back to the debtor during the bankruptcy proceeding constitutes a transfer for tax purposes. Conflicting case law on this important bankruptcy issue is discussed in the section that follows.

II. CONFLICTING CASE LAW ON THE TAXATION OF ABANDONMENTS

Whether the trustee's abandonment of property back to the debtor during the bankruptcy proceeding is a taxable event turns on courts' interpretation of the phrase "in the case of a termination of the estate" in section 1398(f)(2) of the Tax Code. If that phrase is broad enough to include abandonments occurring during the administration of the estate, then an abandonment of property by the trustee will not constitute a taxable event, and the bankruptcy estate will not be liable for taxes on any built-in gain inherent in the property at the time of the abandonment. Conversely, if abandonments during the bankruptcy proceeding are not included within the ambit of section 1398(f)(2), then the trustee's abandonment of property to the debtor will be a taxable event, and the estate will be liable for income tax on any gain inherent in the property.

A. ABANDONMENTS TREATED AS TRANSFERS FOR TAX PURPOSES

The leading case holding that an abandonment of property by the bankruptcy trustee to the debtor during the administration of the bankruptcy estate results in taxable gain to the estate is *In re A.J. Lane & Co.*⁶³ In *A.J. Lane*, the debtor, Andrew J. Lane, filed a bankruptcy petition under chapter 11 of the Bankruptcy Code.⁶⁴ At the time of the filing, Lane owned three commercial apartment complexes in Massachusetts.⁶⁵ All three properties were subject to encumbrances in excess of their fair market value.⁶⁶ A creditor holding the liens on the complexes sought and was granted relief from the automatic stay to proceed with foreclosure sales of the properties.⁶⁷

62. See, e.g., *In re Rubin*, 154 B.R. 897, 899-900 (Bankr. D. Md. 1992) (mem.).

63. 133 B.R. 264 (Bankr. D. Mass. 1991).

64. *Id.* at 266.

65. *Id.*

66. *Id.* at 267.

67. *Id.* at 266.

The chapter 11 trustee sought to abandon the properties as burdensome to the estate because the three properties together had a built-in gain of \$40.9 million, as their fair market value was estimated at \$53 million and they had a combined adjusted basis of \$12.1 million.⁶⁸ If the foreclosure sales occurred while the complexes were still property of the debtor's bankruptcy estate, the estate would incur an income tax liability of \$3.27 million.⁶⁹ The debtor opposed the trustee's motion seeking abandonment of the properties, and filed an ancillary motion seeking a court determination of who should bear the burden of the tax consequences of the foreclosure sales even if the trustee's request for abandonment was granted.⁷⁰ The debtor argued that, if the court permitted the trustee to abandon the properties back to the debtor, the estate would nonetheless remain liable for the taxes on the gain inherent in the properties because the abandonment itself would constitute a taxable event.⁷¹

The court first addressed whether it had the authority to decide which party would be liable for the income taxes inherent in the property if the trustee was permitted to abandon it to the debtor prior to foreclosure.⁷² It concluded that it did hold this authority for two reasons. First, the court noted that the Internal Revenue Service ("Service") had previously issued a private letter

68. *Id.*

69. *Id.* The actual tax liability resulting from the sales was approximately \$13 million; however, the estate succeeded to the debtor's tax attributes, including his net operating losses, upon commencement of the case. *Id.* at 272. Therefore, the estate could offset nearly \$10 million of its tax liability with these net operating losses, but would still have been liable for \$3.27 million in taxes. *See id.*; *see also* I.R.C. § 1398(g) (2000) (providing that the estate succeeds to the debtor's tax attributes at the commencement of the case). For a comprehensive discussion of the concept of net operating losses and their value in bankruptcy, *see* Michelle M. Arnopol, *Why Have Chapter 11 Bankruptcies Failed So Miserably? A Reappraisal of Congressional Attempts to Protect a Corporation's Net Operating Losses After Bankruptcy*, 68 NOTRE DAME L. REV. 133 (1992).

70. *A.J. Lane*, 133 B.R. at 267. The debtor based his request on section 505(a) of the Bankruptcy Code, *id.*, which authorizes a court to establish the parties' relative tax liabilities in a bankruptcy proceeding, *see* 11 U.S.C. § 505(a) (2000).

71. *A.J. Lane*, 133 B.R. at 267.

72. *Id.* at 272. After the court held a hearing on the abandonment issue, but before it reached a decision or the foreclosure sales occurred, the debtor and the trustee were able to refinance the mortgages on two of the three apartment complexes. *Id.* at 266. Therefore, the foreclosures of these properties were discontinued, and the trustee accordingly withdrew his motion to abandon those two properties. *Id.* at 267. The third complex could not be refinanced, however. *Id.* Thus, the bankruptcy court faced the same issue, but with less dire tax ramifications than originally considered. *See id.* at 266-67.

ruling establishing its view that abandonment of property by a bankruptcy trustee was not a taxable event.⁷³ If the court did not decide the tax issue in the case before it, the trustee would seek a determination from the Service after the abandonment took place that the estate should not be liable for any gain inherent in the abandoned property because the abandonment did not constitute a transfer, and therefore was not taxable.⁷⁴ Because the Service and the trustee shared a common view regarding the tax treatment of abandonments, the court reasoned that the debtor's views would not be adequately addressed in such a proceeding, to the debtor's prejudice.⁷⁵ Accordingly, the court found that it was the proper authority to determine the issue.⁷⁶ Moreover, the court stated that "economy in judicial and legal resources dictate that the tax question be adjudicated now; it has been briefed and argued."⁷⁷

Having established itself as the proper tribunal to determine the income tax consequences of the proposed abandonment, the court then discussed whether the debtor was a proper party to whom the trustee could abandon the property. It held that, because the debtor had the right to possess the property at the time he filed for chapter 11 bankruptcy protection, he qualified as a party entitled to receive the abandoned property.⁷⁸

The court finally addressed the primary issue in the case: if the trustee were permitted to abandon the property to the debtor as burdensome to the estate, who would be liable for paying the income taxes on the gain inherent in the property at the time of

73. *Id.* at 267 (citing Priv. Ltr. Rul. 90-17-075 (Jan. 31, 1990)). The court noted that, while the private letter ruling did not address the tax issue in the context of a pending foreclosure proceeding, nevertheless the ruling "certainly indicates the Service's general inclination to consider abandonment a non-taxable event." *Id.*

74. *See id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.* at 268. The court noted, however, that the bank holding the mortgages on the property was also a proper recipient of the abandoned property because it also had possessory rights to the property by virtue of having been granted relief from the automatic stay to foreclose on the property. *Id.* at 269. The court stated that, under Massachusetts law, a party entitled to foreclosure could obtain possession of the property upon the debtor's default on the loan. *Id.* Therefore, the court concluded that the bank's possessory rights to the property were, in fact, superior to the debtor's rights at the time the trustee sought to abandon the property. *Id.*

the abandonment, the estate or the debtor?⁷⁹ The court offered four principal justifications in support of its determination that the estate was liable for the tax liability.

First, the court held that the proposed abandonment would be a taxable event because it would constitute a sale or exchange under the Tax Code.⁸⁰ The court explained that, when a sale or exchange occurs, the taxpayer, here the estate, must recognize gain equal to the excess of the amount realized on the disposition less the adjusted basis of the property transferred.⁸¹ The court recognized that a foreclosure of property by a creditor, even though involuntary to the debtor, was nevertheless a sale or exchange for tax purposes.⁸² Arguing that the trustee's proposed abandonment of the property just prior to foreclosure was the functional equivalent of a foreclosure for tax purposes, the court held that the abandonment was indeed a taxable event to the estate.⁸³

The second justification proffered by the court in support of its holding was based on the judicial doctrine of form over substance,⁸⁴ first espoused in the landmark Supreme Court case entitled *Commissioner v. Court Holding Co.*⁸⁵ In *Court Holding*, the taxpayer was a corporation that had negotiated a sale of its sole asset, an apartment building, with a purchaser and had obtained

79. *See id.*

80. *Id.* at 269–70 (citing I.R.C. § 1001(a) (1988)).

81. *Id.* at 269.

82. *Id.* (citing *Helvering v. Hammel*, 311 U.S. 504, 510 (1941)). The court noted that a foreclosure constituted a sale or exchange even if a nonrecourse liability was being foreclosed upon. *Id.* at 269–70 (citing *Helvering v. Neb. Bridge Supply & Lumber Co.*, 312 U.S. 666 (1941)).

83. *Id.* at 270–71 (citing *Yarbro v. Comm'r*, 737 F.2d 479 (5th Cir. 1984)). The estate's amount realized would depend upon whether the liability that the bank was attempting to foreclose upon was recourse or nonrecourse in nature. *Id.* at 270. If the liability was nonrecourse, then the estate's amount realized would be the fair market value of the indebtedness. *Id.* Similarly, if the liability was recourse, then the amount realized on the transaction would still be the face amount of the indebtedness, but only if the fair market value of the property being foreclosed upon was greater than the amount of the indebtedness. *See id.* If, however, the liability exceeded the fair market value of the property at foreclosure, then the estate's amount realized would only be the fair market value of the property surrendered. *See id.* The difference between the fair market value of the property and the face amount of the indebtedness would constitute discharge of indebtedness income to the estate. *See id.* For a more complete discussion of the concept of discharge of indebtedness income, see *infra* notes 243–58 and accompanying text.

84. *A.J. Lane*, 133 B.R. at 271.

85. 324 U.S. 331 (1945).

a deposit for the purchase.⁸⁶ Because the corporation was advised that the sale would result in the imposition of a large tax liability, it transferred the apartment building to its shareholders and they consummated the sale.⁸⁷ The Supreme Court held that the sale was taxable to the corporation and not to the shareholders.⁸⁸

The bankruptcy court in *A.J. Lane* held that the trustee's proposed abandonment was in essence the same transaction as that attempted in *Court Holding*: the trustee was attempting to transfer property subject to a pending foreclosure sale to the debtor solely to have the debtor, rather than the estate, taxed on the ultimate sale.⁸⁹ As the court quoted from *Court Holding*:

A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.⁹⁰

The court based its third justification for holding that the bankruptcy trustee's proposed abandonment of the apartment complex was a taxable event on traditional notions of statutory interpretation.⁹¹ It first noted that, pursuant to section 1398(f)(2) of the Tax Code, a transfer of property from the estate to the debtor "[i]n the case of a termination of the estate" should not be considered a transfer for tax purposes.⁹² Using a plain-meaning approach to statutory interpretation, the court held that an abandonment of property to the debtor during the administration of the estate did not fall within this statutory exception because it did not occur when the estate terminated upon the conclusion of the bankruptcy proceeding.⁹³ In addition, the court relied on the symmetry between section 1398(f)(2) and section 1398(i) of the Tax Code to conclude that this interpretation was correct.⁹⁴ Under section 1398(i), the debtor succeeds to the tax attributes of the estate "[i]n the case of a termination of [the] estate."⁹⁵ In this instance, it is clear from the structure of the statute that the

86. *Id.* at 332.

87. *Id.* at 333.

88. *Id.* at 334.

89. *A.J. Lane*, 133 B.R. at 271–72.

90. *Id.* at 271 (quoting *Court Holding*, 324 U.S. at 334).

91. *See id.* at 272.

92. *See id.* at 272 (quoting I.R.C. § 1398(f)(2) (1988) (emphasis added)).

93. *See id.*

94. *Id.*

95. I.R.C. § 1398(i) (2000).

phrase “[i]n the case of a termination of [the] estate” refers to the close of the bankruptcy proceeding. To hold that the same phrase in the same section of the statute means something different would do an injustice to the careful construction of the statute:

At the beginning of the case . . . the estate acquires the debtor’s property tax-free along with the debtor’s tax attributes. At the end of the case, or more accurately at the “termination of the estate,” the same is accomplished in reverse. That has not yet occurred here. . . .

. . . The Trustee’s proposed abandonment would destroy this symmetry.⁹⁶

Accordingly, the court held that the abandonment did not fall within the purview of section 1398(f)(2), and therefore was a taxable transfer.⁹⁷

Finally, the court based its holding on the basic bankruptcy policy of promoting the debtor’s fresh start.⁹⁸ Noting that the fresh start policy was controlling in the absence of any other overriding bankruptcy policies, the court concluded that “[t]axing the Debtor on the foreclosure following this proposed abandonment creates a clear burden on the Debtor’s fresh start, and there is no countervailing policy which overrides this consideration.”⁹⁹

Only one other court has followed the *A.J. Lane* court’s holding that the trustee’s abandonment of property to the debtor is a taxable event. In *In re Rubin*,¹⁰⁰ the debtor was a general partner of a real estate limited partnership, Manatee Associates Limited Partnership.¹⁰¹ The partnership was in default on a \$12 million real estate loan.¹⁰² The debtor, Richard Rubin, filed for chapter 11 bankruptcy protection because of the liability that he was facing as a general partner of Manatee.¹⁰³ One of the assets that became part of Rubin’s bankruptcy estate upon filing was his partnership interest.¹⁰⁴ While in bankruptcy, Rubin negotiated a settlement of the loan with the lender on behalf of Manatee.¹⁰⁵ The settlement

96. *A.J. Lane*, 133 B.R. at 272. The court noted that it would be unfair to the debtor if he were taxed on the built-in gain inherent in the apartment complex at the time of the foreclosure because he would not have any tax attributes, such as net operating losses, available against which to offset this gain, as these tax attributes would still be property of the bankruptcy estate. *Id.*

97. *Id.* at 273–74.

98. *Id.* at 274.

99. *Id.*

100. 154 B.R. 897 (Bankr. D. Md. 1992) (mem.).

101. *Id.* at 898.

102. *Id.*

103. *Id.*

104. *See id.*

105. *Id.*

was to result in a tax liability of \$300,000 to the partnership, which would have flowed through to the partners and been reported on their individual income tax returns.¹⁰⁶ Because Rubin was in bankruptcy, however, and the partnership interest was property of his bankruptcy estate, it would have been the estate, and not Rubin personally, that would have been liable for any tax liability resulting from the settlement.¹⁰⁷

The bankruptcy trustee did not seek abandonment of the partnership interest as burdensome to the estate.¹⁰⁸ Therefore, the unsecured creditors' committee, using the authority given to them under the Bankruptcy Code,¹⁰⁹ sought a court order compelling the trustee to abandon the partnership interest before the settlement took place so that the debtor, and not his estate, would be responsible for the tax liability resulting from the transaction.¹¹⁰

The court, relying on the analysis set forth in *A.J. Lane*, held that the proposed abandonment of the partnership interest to the debtor would constitute a taxable event for the estate.¹¹¹ The court found that the plain meaning of section 1398(f)(2) of the Tax Code clearly established that only an abandonment occurring at the termination of the bankruptcy estate could qualify as a nontaxable event.¹¹² It also held that any other holding would impede the debtor's fresh start: "the overriding bankruptcy policy of a fresh start militates against the fundamental unfairness of imposing this burden upon [the] debtor after his emergence from Title 11."¹¹³

106. *Id.*

107. *See id.*

108. *See id.* at 902.

109. *See* 11 U.S.C. § 554(b) (2000); *see also supra* note 34 and accompanying text.

110. *Rubin*, 154 B.R. at 898–99.

111. *Id.* at 899.

112. *Id.* at 900–01.

113. *Id.* at 899. Several other cases have also held that the trustee could not avoid potential tax liability by abandoning property to the debtor. The facts of those cases differ from the cases discussed in this Article, however, because the trustee in each case sought abandonment after the assets in question were already sold. For example, in *Erickson v. United States (In re Bentley)*, 916 F.2d 431 (8th Cir. 1990), the trustee sold the debtor's corn crop, which constituted property of the estate, for a sizeable gain. After the sale, the trustee discovered that the crop was subject to valid liens in excess of its value. *Id.* at 432. Accordingly, the trustee abandoned the proceeds of the corn crop sale and sought a determination from the court that the estate was not liable for the gain on the sale of the crop. *Id.* The Eighth Circuit upheld the district court's holding that the sale of the corn crop was a taxable event, and that the bankruptcy estate was

B. ABANDONMENTS NOT CONSIDERED TRANSFERS FOR TAX PURPOSES

Although the *A.J. Lane* and *Rubin* cases were both well written and carefully reasoned, the majority of courts facing this issue have adopted the opposing view that the trustee's abandonment of property to the debtor during the bankruptcy proceeding is not a taxable event.¹¹⁴ The leading case reaching this conclusion is *Samore v. Olson (In re Olson)*.¹¹⁵ In *Olson*, the debtors, husband and wife, owned two tracts of land that were subject to a mortgage.¹¹⁶ The lender, First Interstate Bank, began foreclosure proceedings when the debtors defaulted on the mortgage.¹¹⁷ After the foreclosure process had begun, the debtors filed a chapter 7 bankruptcy petition, and the tracts of land became property of the debtors' bankruptcy estate.¹¹⁸ The trustee abandoned the properties as burdensome to the estate, and First Interstate Bank then sold the tracts at a properly authorized foreclosure sale.¹¹⁹ The trustee then sought a determination from the court that the abandonment was not a sale or exchange under the Tax Code, and therefore did not result in taxable gain to the bankruptcy estate.¹²⁰

indeed responsible for the tax liability imposed on the inherent gain at the time of the sale. *Id.* at 433. The court held that even if the abandonment was not a taxable event for the bankruptcy estate, the sale of the property had already occurred prior to the abandonment, and it was too late to shift the tax consequences to the debtor at that time. *Id.*; see also *In re Perlman*, 188 B.R. 704, 706 (Bankr. S.D. Fla. 1995) ("The Trustee's sale of estate property was a taxable event that cannot be undone by an attempted retroactive abandonment of the assets or by an abandonment of the sale proceeds.").

114. See, e.g., *Samore v. Olson (In re Olson)*, 930 F.2d 6, 8 (8th Cir. 1991) (per curiam); *In re Popp*, 166 B.R. 697, 699 (Bankr. D. Neb. 1993) (mem.); *Terjen v. Santoro (In re Terjen)*, 154 B.R. 456, 458 (E.D. Va. 1993), *aff'd*, 30 F.3d 131 (4th Cir. 1994) (unpublished table decision); *In re Burpo*, 148 B.R. 918, 920 (Bankr. W.D. Mo. 1993).

115. 930 F.2d 6 (8th Cir. 1991) (per curiam).

116. *Id.* at 7.

117. *Id.*

118. See *id.*

119. *Id.*

120. *Id.* at 7-8. The debtors did not object to the trustee's abandonment of the land to them during the bankruptcy proceeding. *Id.* The tax issue arose because, following the foreclosure sale, the debtors hired accountants to prepare and file income tax returns on behalf of the estate without the trustee's authority. *Id.* The debtors instructed the accountants to report the gain inherent in the properties on the estate's tax return because the trustee's abandonment was a taxable event. *Id.* The trustee then initiated this adversary proceeding against the debtors, seeking a determination from the court that the abandonment was not a sale or exchange and, accordingly, the estate was not liable for the tax. See

In a very brief opinion, the Eighth Circuit affirmed the determinations of both the bankruptcy and district courts that the trustee's abandonment of estate property to the debtors was not a taxable transfer.¹²¹ Citing section 1398(f)(2) of the Tax Code for the proposition that a transfer of property from the bankruptcy estate to the debtor at the conclusion of the case was not a taxable event, the court reasoned that it could see "no reason why abandonment during the administration of the case should have a different effect."¹²² The court recognized that the tracts of land ceased to be property of the estate upon abandonment and that title to the land thereby reverted back to the debtors.¹²³ Thus, because the abandonment was not a taxable event and the land was no longer property of the bankruptcy estate at the time of the foreclosure sale, the debtors, and not the estate, were responsible for the income tax liability on any gain inherent in the land at the time of the sale.¹²⁴

Although *Olson* is the only appellate decision concluding that abandonment is not a taxable event,¹²⁵ several district and bankruptcy court decisions have relied on *Olson* to reach the same conclusion.¹²⁶ For example, in *Terjen v. Santoro (In re Terjen)*,¹²⁷ the trustee abandoned real property back to the debtor as of inconsequential value to the estate because it was encumbered by liabilities in excess of its fair market value.¹²⁸ The debtor objected to the proposed abandonment, arguing in part that the proposed abandonment would not shift the taxable gain from the estate to the debtor because the abandonment itself was a taxable event.¹²⁹

The district court found the trustee's abandonment of the property to be appropriate, and held that the abandonment did

id.

121. *Id.* at 8.

122. *Id.* (citing I.R.C. § 1398(f)(2) (1986)).

123. *Id.*

124. *Id.*

125. There is one other appellate decision permitting the trustee to abandon property as burdensome to the estate based on the adverse tax consequences that would result if the estate continued to hold the property at the time of foreclosure. *Johnston v. Webster (In re Johnston)*, 49 F.3d 538, 541 (9th Cir. 1995). The Ninth Circuit, however, expressly declined to opine on the tax consequences of the proposed abandonment to the debtors or the estate. *See id.*

126. *See* cases cited *supra* note 114.

127. 154 B.R. 456 (E.D. Va. 1993), *aff'd*, 30 F.3d 131 (4th Cir. 1994) (unpublished table decision).

128. *See id.* at 457.

129. *Id.* at 457-58.

not constitute a taxable event.¹³⁰ Refusing to read section 1398(f)(2) of the Tax Code narrowly to apply only to transfers by the estate to the debtor at the termination of the bankruptcy case, the court instead adopted “the view of other courts which have included abandonments by the trustee during the pendency of bankruptcy within section 1398(f)(2).”¹³¹

Similarly, a Missouri bankruptcy court followed *Olson* as precedential authority on the abandonment issue in *In re Burpo*,¹³² a case with facts nearly identical to those in *Olson* and *Terjen*. Although the court was sympathetic to the debtors’ argument that they would be liable for recognizing the gain inherent in the properties if the trustee were allowed to abandon them before foreclosure, it nevertheless felt compelled to follow the Eighth Circuit’s decision that abandonment was not a taxable event for the bankruptcy estate.¹³³ Addressing the debtors’ argument that its holding would deny them their fresh start after bankruptcy, the court stated:

This Court recognizes that the thrust of the Bankruptcy Reform Act of 1978 is to afford honest debtors a fresh start. Unfortunately, that is not always possible. In this case, the Court regrets that debtors fall within that unfortunate group that Congress has declared cannot be absolved of all economic sins and truly be born again.¹³⁴

The Internal Revenue Service has consistently followed the holding in *Olson* when responding to ruling requests from taxpayers. In Private Letter Ruling 96-11-028,¹³⁵ for example, the debtors filed for chapter 11 bankruptcy protection on August 2, 1991. Certain properties owned by the debtors, including several limited partnership interests, were abandoned by the trustee to the debtor as burdensome to the bankruptcy estate.¹³⁶ The Service ruled that the abandonments would not be treated as taxable dispositions by the bankruptcy estate, citing *Olson* as authority for its position.¹³⁷

130. *Id.* at 458.

131. *Id.* (citing *In re Olson*, 930 F.2d 6, 8 (8th Cir. 1991) (per curiam); *In re McGowan*, 95 B.R. 104, 107 (Bankr. N.D. Iowa 1988) (mem.)).

132. 148 B.R. 918, 920 (Bankr. W.D. Mo. 1993).

133. *Id.* The court did acknowledge that it had read the *A.J. Lane* decision “with interest and respect.” *Id.*

134. *Id.*

135. Priv. Ltr. Rul. 96-11-028 (Dec. 14, 1995).

136. *Id.*

137. *Id.*; see also Priv. Ltr. Rul. 92-45-023 (Aug. 7, 1992) (“[T]he abandonment of property from a bankruptcy estate to a debtor is not a taxable disposition giving rise to gain or loss.”); Priv. Ltr. Rul. 90-17-075 (Jan. 31, 1990) (concluding that the phrase “termination of the estate” in I.R.C. § 1398(f)(2) was

From a strict statutory construction perspective, there can be little doubt that *A.J. Lane* and its progeny represent the correct interpretation of section 1398(f) of the Tax Code. Recall that the Tax Code states that a transfer of property from one taxpayer to another is a taxable event unless a provision of the Code specifically provides otherwise.¹³⁸ Section 1398(f) provides that a transfer of property from the estate to the debtor is not a taxable transfer so long as it occurs upon the “termination of the estate.”¹³⁹ The clear implication of section 1398(f) is that a transfer of property from the estate to the debtor before the termination of the bankruptcy estate is a taxable event. Does the trustee’s abandonment of property to the debtor during the pendency of a bankruptcy proceeding occur at the termination of the estate?

It is a well-settled matter of case law that a dictionary can often be a useful tool in attempting to discern the plain meaning of a statute.¹⁴⁰ According to a dictionary, “termination” means an “end in time or existence” or a “conclusion.”¹⁴¹ It is clear from even a cursory reading of section 1398(f) that the term “termination” refers to the bankruptcy estate.¹⁴² It is equally clear that an abandonment of property occurs while the estate is still in existence.¹⁴³ Thus, under a plain reading of the statute, an abandonment does not occur at the “conclusion” of the estate, or at the end of its “existence.”

Accordingly, *A.J. Lane* and its progeny were correct in holding that a trustee’s abandonment of property to the debtor during a bankruptcy proceeding was a taxable event because the abandonment did not occur upon the “termination of the estate.”¹⁴⁴ *Ol-*

broad enough to encompass “the termination of the estate’s interest in property by virtue of abandonment”).

138. See I.R.C. § 1001(a) (2000) (stating that a “sale or other disposition” of property results in a realized gain or loss equal to the amount realized on the disposition less the adjusted basis of the property transferred).

139. See *id.* § 1398(f)(2).

140. See, e.g., *Nix v. Hedden*, 149 U.S. 304, 307 (1893) (using a dictionary to discern whether tomatoes are “fruit” or “vegetables” under the Tariff Act of 1883); see also WILLIAM N. ESKRIDGE, JR., ET AL., LEGISLATION AND STATUTORY INTERPRETATION 251–52 (2000) (stating that since *Nix v. Hedden* the Court has “increasingly relied on dictionaries in discerning ordinary meaning”).

141. MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 1289 (11th ed. 2003).

142. I.R.C. § 1398(f)(2) (“In the case of a termination of the estate . . .”).

143. See, e.g., *Samore v. Olson (In re Olson)*, 930 F.2d 6, 7 (8th Cir. 1991) (per curiam); *In re A.J. Lane & Co.*, 133 B.R. 264, 272 (Bankr. D. Mass. 1991).

144. See *supra* notes 92–97 and accompanying text. *A.J. Lane*’s interpretation of the statutory language of section 1398(f) can also be supported under well-settled canons of statutory construction. For example, a widely accepted

son's holding that the phrase "termination of the estate" was broad enough to encompass a termination of the estate's interest in property upon its abandonment is simply misplaced.¹⁴⁵ While *A.J. Lane* is correct as a matter of strict statutory construction, however, it can be challenged from a policy perspective.

III. COMPETING TAX AND BANKRUPTCY POLICIES

Legal scholarship in the field of debtor and creditor relations tends to focus exclusively on the bankruptcy aspects of a vexing legal issue; very few scholars have attempted to harmonize the often conflicting bankruptcy and tax policies underlying these issues.¹⁴⁶ Similarly, the congressional committees devoted to addressing tax issues, the House Ways and Means Committee and the Senate Finance Committee, have often been criticized for passing bankruptcy tax measures as part of an overall tax reform bill without consulting or coordinating with their committee counterparts devoted to bankruptcy issues, the House and Senate Judiciary Committees.¹⁴⁷ Thus, neither academic literature nor

notion of statutory interpretation, the whole act rule, suggests that a statute should be interpreted as a whole, so that the interpretation of one provision of the statute does not render it inconsistent with another provision. *See, e.g., United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988); *see also* ESKRIDGE, JR., ET AL., *supra* note 140, at 263–66. As the court in *A.J. Lane* suggests, to interpret section 1398(f) to include abandonments would be inconsistent with section 1398(i), which states that the debtor succeeds to all of the estate's unused tax attributes upon the "termination of the estate." *See A.J. Lane*, 133 B.R. at 272–73. As one leading treatise has suggested, section 1398(i) and section 1398(f) complement one another:

Taken together, these sections provide that, at the termination of the estate, all assets and tax attributes left in the estate are returned to the debtor. This gives the debtor an opportunity to use any remaining tax attributes to offset gain that might be inherent in the property. To provide for the tax-free disposition of property from the estate to the debtor without the concurrent transfer of tax attributes would distort the statutory framework set out in section 1398.

JAMES F. QUEENAN ET AL., CHAPTER 11 THEORY AND PRACTICE: A GUIDE TO REORGANIZATION § 25:71, at 25:85 (1994).

145. *See supra* notes 122–24 and accompanying text.

146. This paragraph borrowed heavily from Michelle Arnopol Cecil, *Reinvigorating Chapter 11: The Case for Reinstating the Stock-for-Debt Exception in Bankruptcy*, 2000 WIS. L. REV. 1001, 1042.

147. *See, e.g.,* Letter from Representative Jack Brooks, Chairman, House Judiciary Committee, to Representative Dan Rostenkowski, Chairman, House Committee on Ways and Means 2 (July 15, 1993) (on file with author) ("I believe it is desirable for the overall economic policy that changes in the tax law not come at the expense of longstanding bankruptcy policy and not threaten this nation's job base."); *see also* Steven J. Csontos et al., *Congress's Role in Tax Policy: A Roundtable Discussion*, 3 AM. BANKR. INST. L. REV. 257, 292–93 (1995);

recent legislation has explored the intersection of these two vast bodies of law. Resolving the issue of how to treat bankruptcy abandonments for tax purposes is one small step toward harmonizing bankruptcy and tax policy. Yet before a resolution can be crafted, it is necessary to ascertain the bankruptcy and tax policies underlying the abandonments issue and how these policies are in conflict.

A. TAX POLICIES RELATING TO ABANDONMENTS¹⁴⁸

A fundamental tenet of tax law is that the imposition of a tax should correspond with the taxpayer's ability to pay the resulting liability.¹⁴⁹ Thus, one of the first and most elementary tax concepts is that gains are taxed only when they are "realized."¹⁵⁰ A realization event occurs when a taxpayer sells, exchanges, or oth-

Robert A. Jacobs, *The Bankruptcy Court's Emergence as Tax Dispute Arbiter of Choice*, 45 TAX LAW. 971, 1029 (1992).

148. The first three paragraphs of this subsection have been adapted from Michelle Arnopol Cecil, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses*, 1999 U. ILL. L. REV. 1083, 1095-96.

149. See, e.g., PHILIP D. OLIVER & FRED W. PEEL, JR., TAX POLICY 50 (1996); U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 81 (1977); see also Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 MICH. L. REV. 365, 366 (1988) (stating that in the U.S. tax system, a taxpayer's taxable income in part reflects the extent to which a tax liability might impose an undue hardship on the taxpayer); Sam K. Kaywood, Jr., Comment, *The Deficit Reduction Act of 1984: Reform for Deferred Payment Accounting*, 35 EMORY L.J. 507, 513 (1986) (stating that the policy behind the cash receipts and disbursements method is that tax liability should be linked to the taxpayer's ability to pay).

150. The realization requirement first became a part of the Tax Code in 1924 and was codified as section 202(a) of the Revenue Act of 1924, Revenue Act of 1924, ch. 234, 43 Stat. 253, 255 (1924). Although the requirement has been relocated to numerous other Code sections throughout the years, it has consistently remained a part of the structure of the Tax Code. Today, the realization requirement is contained in I.R.C. § 1001(a)-(b).

As one noted tax scholar stated, "[t]he principle of realization has historically been central to the jurisprudence of the federal income tax." Edward A. Zelinsky, *For Realization: Income Taxation, Sectorial Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 861 (1997). Although a discussion of how the realization concept has evolved over time is beyond the scope of this Article, it is discussed in some detail in Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, 10-14 (1992). There are, however, scholars who have attacked the realization concept as improper as a matter of tax policy. See, e.g., Stephen B. Land, *Defeating Deferral: A Proposal for Retrospective Taxation*, 52 TAX L. REV. 45, 48-59 (1996); see also *infra* note 153 and accompanying text.

erwise disposes of an asset.¹⁵¹ Because taxpayers can carefully time when they will be taxed on their gains, if at all,¹⁵² tax scholars have attacked the realization concept for years as antithetical to an ideal income tax base.¹⁵³

Over half a century ago, two noted economists independently attempted to define what would constitute an ideal and comprehensive income tax base. These economists, Robert Haig and Henry Simons, concluded that income should be defined as the sum of the taxpayer's consumption plus any changes in her net worth over the relevant accounting period.¹⁵⁴ Under the Haig-Simons definition of income, tax deferral would be impermissible; therefore, any appreciation in the fair market value of an asset would be taxed each year as it accrues, rather than waiting until the asset is sold and the gain is realized.¹⁵⁵ For example, assume that a taxpayer purchased an apartment building for \$800,000 in 1999. If that building appreciated in value to \$880,000 in 2000, under the Haig-Simons system the taxpayer would be taxed on \$80,000 in 2000, the amount representing the appreciation that accrued during that year. Taxing this appreciation annually is justified because the taxpayer has already enjoyed the benefits of the property's appreciation in value, including its use and myriad economic benefits, such as the ability to pledge the property as collateral for a loan and a potential increase in depreciation de-

151. See I.R.C. § 1001 (2000) (providing rules for determining calculation of gain or loss on the sale or disposition of property).

152. When property is acquired by bequest, devise, or inheritance, the basis of the property in the hands of the recipient will generally be its fair market value on the date of the decedent's death, unless an alternative valuation date is chosen. See I.R.C. § 1014 (2000). Thus, all of the gain inherent in the property at the time of the decedent's death will escape taxation forever. For a more comprehensive discussion of this stepped-up basis at death, and its repeal beginning in 2011, see *infra* notes 178–80 and accompanying text.

153. See, e.g., DAVID F. BRADFORD & U.S. TREASURY TAX POLICY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 5 (2d ed., rev. 1984); Land, *supra* note 150, at 48; Shaviro, *supra* note 150, at 10–14.

154. See HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938); Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 1, 7 (Robert Murray Haig ed., 1921), reprinted in 9 READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl S. Shoup eds., 1959). More specifically, Simons defined income as “the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.” SIMONS, *supra*, at 50.

155. See Land, *supra* note 150, at 48.

ductions associated with the property.¹⁵⁶ Under Haig-Simons, if the taxpayer then filed for chapter 7 bankruptcy protection in January 2001, there would be no gain inherent in the property at the time of filing because the taxpayer would have already included the appreciation in income annually as it accrued. Accordingly, the issue of how to tax abandonments in bankruptcy would not arise because the trustee would never be forced to abandon otherwise valuable property merely because of the adverse tax consequences that might inure to the bankruptcy estate.

Nevertheless, the realization requirement has been a mainstay of the Tax Code almost since the Code's inception in 1913.¹⁵⁷ Although the realization concept can be justified on several policy grounds, each centers on the fundamental concept of administrative feasibility.¹⁵⁸ It is simply impracticable to tax gains annually as they accrue because of the valuation and liquidity problems associated with such a tax.¹⁵⁹ Even Henry Simons, a principal architect of the Haig-Simons definition of an ideal income tax base, noted that "[t]he realization criterion is not only indispensable to a feasible income-tax system but relatively unobjectionable in principle where it results only in postponement of assessment."¹⁶⁰ Moreover, such an accrual system would require that the government compensate a taxpayer for losses as they accrue as well, an approach that would not only be impossible to administer but would lead to ludicrous results.¹⁶¹ Thus, it is realization that cre-

156. See, e.g., 1 NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS—NATIONAL BANKRUPTCY REVIEW COMMISSION FINAL REPORT 971 (1997).

157. For a discussion of the history of the realization concept, see *supra* note 150.

158. It is important to understand that not all tax scholars accept administrative feasibility as enough of a justification to abandon Haig-Simons in favor of realization. See, e.g., Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 724–28 (1990); see also Land, *supra* note 150, at 59–73 (discussing administrative methods used to limit the realization requirement).

159. See David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1113–14 (1986). For a more comprehensive discussion of the problems of liquidity and valuation, see Cecil, *supra* note 148, at 1096–98.

160. SIMONS, *supra* note 154, at 162.

161. Under a true accretion-type tax system, a decrease in income, which includes a reduction in a taxpayer's net worth over his annual accounting period, would require the government to return the unfortunate taxpayer's losses in the form of a tax refund. See MARTIN DAVID, *ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION* 166 (1968); see also Fellows, *supra* note 158, at 803–04 (discussing tax treatment of net losses). From a practical perspective, such

ates the adverse tax consequences associated with bankruptcy abandonments. Yet retaining the realization requirement as a fundamental attribute of the federal income tax system continues to be an administrative necessity.

Under the current tax system, realized gains must be recognized, or included in the taxpayer's gross income, in the year in which the realization event occurs.¹⁶² Accordingly, as a matter of fundamental tax policy, the built-in gain inherent in property must be taxed upon a sale or other disposition of the property, even if that sale or disposition occurs during a bankruptcy proceeding. To hold otherwise would allow the bankruptcy system to be used merely as a mechanism to avoid an otherwise valid tax liability. But who should bear the burden of that tax in the bankruptcy context, the debtor or the bankruptcy estate? Traditional notions of tax policy dictate that, because it was the debtor who enjoyed the appreciation that accrued in an asset before the filing of the bankruptcy petition, it should be the debtor who bears the burden of the tax on that pre-petition appreciation in bankruptcy, irrespective of whether the trustee sells or exchanges the property during the bankruptcy proceeding or instead abandons it to the debtor, where it is sold or exchanged while property of the debtor.¹⁶³

a refund program would strain government revenues, perhaps to the breaking point. See Fellows, *supra* note 158, at 804 (suggesting that a refund rule would be "politically unacceptable").

162. See I.R.C. § 1001 (2000). A realized gain must be recognized unless the taxpayer's sale or disposition qualifies for one of the Tax Code's nonrecognition provisions. See *id.* § 1001(c). If a nonrecognition provision applies to a transaction, the realized gain is not included in the taxpayer's income in the year of the disposition; however, the gain is preserved and is taxed at a later time. Thus, nonrecognition provisions merely defer the inclusion of gain in income; they do not operate to exclude the gain from taxation forever. See, e.g., *id.* § 351 (deferring recognition of gain on the formation of a corporation); *id.* § 453 (permitting the recognition of gain over time for an installment sale); *id.* § 1031 (deferring recognition of gain in a like-kind exchange). There is one major exception to the concept that realized gains must be recognized, either currently or in the future. A taxpayer may exclude up to \$250,000 from income (\$500,000 for married taxpayers filing joint tax returns) on the sale or exchange of a principal residence if certain requirements are met. See *id.* § 121.

163. See, e.g., 1 NAT'L BANKR. REVIEW COMM'N, *supra* note 156, at 970-71. The proposal outlined in Part V of this Article discusses this concept in greater detail. It also answers the question of who should bear the burden of tax on the appreciation that accrues after the filing of the bankruptcy petition. See *infra* notes 279-80 and accompanying text.

B. CONFLICTING BANKRUPTCY POLICIES

Although as a matter of pure tax policy the built-in gain inherent in property should not escape taxation entirely merely because the taxpayer has filed for bankruptcy protection, what of bankruptcy policy?¹⁶⁴ The twin policies underlying the bankruptcy system are to ensure fair and equitable distribution to all creditors,¹⁶⁵ in part by maximizing the bankruptcy estate for the benefit of those creditors,¹⁶⁶ and to preserve the debtor's fresh start after bankruptcy.¹⁶⁷ If an abandonment by the trustee is treated as a taxable event to the bankruptcy estate, the income taxes owed on the resulting gain will deplete the estate's assets, thereby defeating the bankruptcy policy of maximizing the distribution to unsecured creditors. Conversely, if the abandonment is not treated as a taxable event to the estate, the debtor, rather

164. Some bankruptcy scholars argue that recent bankruptcy reform legislation is no longer grounded in sound bankruptcy policy; rather, it is the product of intense pressure by lobbyists and largely supports only special interest groups. See William T. Bodoh & Lawrence P. Dempsey, *Bankruptcy Reform: An Orderly Development of Public Policy?*, 49 CLEV. ST. L. REV. 191, 193-94 (2001).

165. See *Burlingham v. Crouse*, 228 U.S. 459, 473 (1913); see also *IRS v. Luongo (In re Luongo)*, 259 F.3d 323, 330 (5th Cir. 2001) ("The bankruptcy court's responsibility in administering the estate is . . . to achieve a fair and equitable distribution of assets to the creditors . . ."); BENJAMIN WEINTRAUB & ALAN N. RESNICK, *BANKRUPTCY LAW MANUAL* ¶ 1.02[1][d] (3d ed. 1992) (recognizing that one purpose of bankruptcy is "the conversion of the debtor's assets into cash for equal distribution among creditors").

To be sure, not all creditors are treated identically in bankruptcy. Secured creditors are treated more favorably than unsecured creditors, and certain unsecured creditors' claims are given priority over other unsecured claims. See 11 U.S.C. §§ 502, 506, 507 (2000); see also Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 785-86 (1987) ("[A] significant part of [the Bankruptcy Code's] distributional scheme is oriented toward establishing priorities among creditors.").

166. See, e.g., Bodoh & Dempsey, *supra* note 164, at 194.

167. See H.R. REP. NO. 95-595, at 125 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6086 (noting that the fresh start allows debtors "to get out from under the debilitating effects of too much debt" and that "[t]he two most important aspects of the fresh start available under the Bankruptcy laws are the provision of adequate property for a return to normal life, and the discharge, with the release from creditor collection attempts"); see also 147 CONG. REC. H133 (daily ed. Jan. 31, 2001) (statement of Rep. Gekas) ("[T]he real purpose of bankruptcy reform or any bankruptcy legislation [is] to allow an American citizen the right to gain a fresh start after finding himself incapable of meeting his obligations."); Miles, *supra* note 20, at 799-800 ("The [bankruptcy] system must be fair. Critical to the achievement of fairness of course is balance: that is, balance between the debtor's obtaining a 'fresh start'; the need to pay the debtor's obligations to creditors; and the need for balance between competing creditors." (footnotes omitted)).

than the bankruptcy estate, will be liable for paying taxes on the asset's built-in gain. Such a tax liability would diminish the debtor's ability to enjoy a fresh start, frustrating the second policy justification for the bankruptcy system. Is there a tax resolution to this vexing issue that can harmonize these competing bankruptcy policies?

IV. EXISTING PROPOSALS FOR RESOLVING THE BANKRUPTCY ABANDONMENT ISSUE

This is not the first scholarly article or study to recognize the complex bankruptcy and tax policies that are implicated when a bankruptcy trustee abandons property to a debtor during the administration of a bankruptcy estate. Four other significant works have proposed solutions to the problem of how to tax abandonments in bankruptcy. Although none of these proposals offers a complete resolution to the problem, each proposal nevertheless provides valuable insights. Because this Article builds on the ideas of those who have studied the issue in the past, this section will explore each of these proposals in detail.

A. THE COMMERCIAL LAW LEAGUE OF AMERICA PROPOSAL

In March 1996, the Commercial Law League of America conducted an empirical study designed to measure whether bankruptcy abandonments had a significant effect on the distribution of assets to creditors in chapter 7 bankruptcy proceedings.¹⁶⁸ The study was predicated on the hypothesis that trustees were abandoning assets to debtors rather than selling them for the benefit of creditors because of the adverse tax impact that the sales of those assets would have on the bankruptcy estate.¹⁶⁹ The study examined a four-year period between 1992 and 1995 and was sent to approximately 600 bankruptcy trustees across the United States.¹⁷⁰

The results of the Commercial Law League's study were staggering. It found that 11,933 cases involved assets that the trustee abandoned to the debtor or simply did not sell because the capital gains liability resulting from the sales would have

168. See Moses, *supra* note 23, at 219.

169. See Commercial Law League of Am., *supra* note 24, at 21.

170. See Moses, *supra* note 23, at 219. The trustees selected for inclusion in the study were active chapter 7 bankruptcy trustees who were members of the National Association of Bankruptcy Trustees. *Id.*

been overly burdensome to the estate.¹⁷¹ The study concluded that “[e]xclusive of the potential capital gain taxes and the obligations owed to the creditors secured by the assets, the net amount which was not available to the estates for distribution to the unsecured creditors totaled \$78,511,000.”¹⁷² Because only twenty-five percent of the bankruptcy trustees who received the survey responded to its questionnaire, the Commercial Law League estimated that the actual amount unavailable to unsecured creditors during the four-year testing period was closer to \$340,000,000.¹⁷³

These results are significant because they offer the first glimpse into the magnitude of the abandonment issue. As the study suggests, because trustees are abandoning property to debtors or simply allowing it to revert back to the debtors upon termination of the bankruptcy estate because of the adverse tax consequences associated with selling the property, unsecured creditors “are being deprived of a source of funds from which they could recoup some portion of the billions lost each year to bankrupt debtors.”¹⁷⁴

The Commercial Law League concluded its study by proposing to the National Bankruptcy Review Commission that chapter 7 bankruptcy trustees receive a “stepped-up basis” in property of the debtor that becomes part of the estate, thereby eliminating the estate’s tax liability upon the sale of the property in bankruptcy.¹⁷⁵ “As one of the goals of bankruptcy is to enhance creditor distributions, eliminating the disincentives that force the abandonment would benefit the creditor community and [the] bankruptcy system as a whole.”¹⁷⁶

Although the Commercial Law League’s empirical study re-

171. *Id.* at 220; Commercial Law League of Am., *supra* note 24, at 21.

172. Commercial Law League of Am., *supra* note 24, at 21. The study established that the amount unavailable to debtors’ unsecured creditors averaged over \$1.1 million for each of the 136 trustees that responded to the survey. *See id.* It is interesting to note that the trustees responding were very experienced bankruptcy trustees, with an average length of service of 11.58 years and an average caseload over the four-year survey period of 2320 cases. *Id.*

173. Moses, *supra* note 23, at 220.

174. Commercial Law League of Am., *supra* note 24, at 21.

175. *See id.* at 22; Moses, *supra* note 23, at 219. According to the study, this stepped-up basis proposal would operate in a manner similar to provisions that provide heirs a stepped-up basis in the decedent’s assets on death. Commercial Law League of Am., *supra* note 24, at 21. For a glimpse at the provision offering heirs a stepped-up basis on the decedent’s death, see I.R.C. § 1014 (2000). It is important to note that this provision will be repealed beginning in 2011. *See* 26 U.S.C.A. § 1022 (West 2002); *see also infra* note 180 and accompanying text.

176. Moses, *supra* note 23, at 219.

sults provide a significant contribution to any discussion of the bankruptcy abandonment issue, the study's proposed solution is unfeasible for both practical and policy reasons. First, from a tax policy perspective, because the debtor enjoyed the benefits of the appreciation inherent in his assets before bankruptcy, that appreciation should be subject to taxation when the assets are sold or otherwise disposed of, whether that sale or disposition occurs during or after bankruptcy. To offer the trustee a stepped-up basis in the debtor's assets when they are transferred into the bankruptcy estate would frustrate the well-established policy of taxing gains when they are realized.¹⁷⁷ While it is true that a decedent's assets receive a stepped-up basis at death, so that the gains inherent in those assets are never taxed,¹⁷⁸ most tax scholars agree that the provision allowing a stepped-up basis at death is contrary to tax policy and should be abolished.¹⁷⁹ Moreover, that provision has, in fact, been repealed for decedents dying after December 31, 2009.¹⁸⁰ Therefore, reliance on the stepped-up

177. For a discussion of the realization concept, see *supra* notes 150–62 and accompanying text.

178. When property is acquired by bequest, devise, or inheritance, the basis of the property in the hands of the recipient will generally be its fair market value at the date of the decedent's death (unless a statutorily provided alternative valuation date is chosen), rather than the decedent's original basis in the property. I.R.C. § 1014(a). Thus, this basis (as adjusted) will be used to determine the recipient's gain or loss when the property is later sold or exchanged. I.R.C. §§ 1001, 1011 (2000); see also *Hess v. United States*, 537 F.2d 457, 462 (Ct. Cl. 1976). Accordingly, any unrealized gain attributable to the period during which the decedent held the property escapes tax permanently. *E.g.*, Shaviro, *supra* note 150, at 16.

179. *E.g.*, Noël B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 346 (1993); Joseph E. Snoe, *Tax Simplification and Fairness: Four Proposals for Fundamental Tax Reform*, 60 ALB. L. REV. 61, 82 (1996).

180. See 26 U.S.C.A. § 1022 (West 2002). The provision allowing a stepped-up basis at death is scheduled to be repealed at the same time that the estate tax is repealed. H.R. CONF. REP. NO. 107-84, at 193 (2001), reprinted in 2001 U.S.C.C.A.N. 46, 118. When the new law takes effect in 2010, the basis of property acquired from a decedent through a will or through intestacy will be the lesser of the decedent's adjusted basis in the property or its fair market value at the time of his death. 26 U.S.C.A. § 1022(a)(2) (West 2002). Section 1022 also allows the executor of the decedent's estate to increase the aggregate basis in the decedent's assets by \$1.3 million, so long as the basis for any asset is not increased above its fair market value. See *id.* § 1022(b)(2)(B), (d)(2). Finally, for property passing to the decedent's spouse, the executor can increase the aggregate basis of such property by an additional \$3 million, subject again to the caveat that the basis for any asset cannot be increased above its fair market value. *Id.* § 1022(c)(2)(B), (d)(2). These provisions are currently scheduled to sunset beginning in 2011. See *id.* § 1022.

basis at death as support for the Commercial Law League's proposal is unpersuasive.¹⁸¹

Not only is the proposal difficult to justify from a policy perspective, it is administratively unfeasible as a practical matter as well. The federal government would lose a large source of revenue if Congress adopted the Commercial Law League's proposal.¹⁸² The proposal disputes this massive revenue loss, arguing that, under current law, this property reverts back to the debtor and the gain inherent in the property escapes taxation through a number of provisions, including the exclusion of gain from the sale of a principal residence and the like-kind exchange provisions.¹⁸³ The Commercial Law League provides no support for this conclusion, however, and case law suggests otherwise. In virtually all of the cases outlined above in which the trustee abandoned property to the debtor because of the adverse tax consequences that would accrue to the estate if the trustee had instead sold the property, the facts indicated that secured creditors immediately foreclosed on the property upon its abandonment to the debtor.¹⁸⁴ Because foreclosure is a taxable event, the debtors in those cases were forced to recognize the gain inherent in the

181. Although the stepped-up basis provision had not, in fact, been repealed when the Commercial Law League presented its proposal to the National Bankruptcy Review Commission in 1997, it had been subject to significant criticism by tax commentators for years. See *supra* note 179 and accompanying text.

182. While no empirical studies have been conducted to quantify the revenue loss resulting from the Commercial Law League's proposal, empirical studies have indicated that approximately one-half of all capital gains inherent in property are never taxed because of the stepped-up basis at death, the provision upon which the Commercial Law League's proposal is modeled. See, e.g., MERVYN A. KING ET AL., *THE TAXATION OF INCOME FROM CAPITAL* 221 (Mervyn A. King & Don Fullerton eds., 1984); Cunningham & Schenk, *supra* note 179, at 344.

183. See Moses, *supra* note 23, at 220 (noting that if the debtor decides to sell the property that has been abandoned by the trustee or that has reverted back to the debtor at the termination of the bankruptcy estate, "it more than likely would not result in a taxable event or any gain realized would be excluded from the taxpayers [sic] taxable income," due to "a number of tax code provisions, such as the 'over 55 exclusion of income,' property being transferred by death, § 1031 exchanges, and other legitimate tax saving devices").

184. *Samore v. Olson* (*In re Olson*), 930 F.2d 6, 7 (8th Cir. 1991) (per curiam); *Terjen v. Santoro* (*In re Terjen*), 154 B.R. 456, 457 (E.D. Va. 1993), *aff'd*, 30 F.3d 131, 131 (4th Cir. 1994) (unpublished table decision); *In re Burpo*, 148 B.R. 918, 919 (Bankr. W.D. Mo. 1993); *In re A.J. Lane & Co.*, 133 B.R. 264, 266 (Bankr. D. Mass. 1991); see also Williams, *supra* note 58, at 29 ("[A]bandonment chiefly concerns valuable property that is overencumbered with liens. Therefore, once abandonment occurs, a secured party almost always appears seeking to foreclose on the property."). For a more comprehensive discussion of the facts underlying the cases cited in this footnote, see *supra* notes 63–145 and accompanying text.

property upon its foreclosure.¹⁸⁵ Although there is no empirical evidence to suggest the magnitude of the revenue loss that would occur if the Commercial Law League's proposal were adopted, the results of its own study suggest that the numbers would be staggering.¹⁸⁶ Accordingly, this stepped-up basis proposal is administratively unfeasible and should be rejected as a possible solution to the abandonment dilemma.

B. THE NATIONAL BANKRUPTCY REVIEW COMMISSION REPORT

As part of the Bankruptcy Reform Act of 1994,¹⁸⁷ Congress established the National Bankruptcy Review Commission to examine how current bankruptcy law was operating in practice and to propose specific recommendations for amending the Bankruptcy Code to alleviate problems associated with its practical application.¹⁸⁸ On October 20, 1997, the Commission issued its final report to Congress, a section of which was devoted exclusively to bankruptcy taxation issues.¹⁸⁹

In addressing the issue of taxation of abandonments in bankruptcy, the Commission's report recognized that the majority rule established by the courts, that an abandonment is not treated as a transfer for tax purposes, is unfair to debtors because it requires them to pay tax on the gain inherent in their property when it is disposed of without the benefit of net operating losses and other tax attributes against which to offset the gain.¹⁹⁰ Conversely, the report stated that the current minority rule, that an abandonment is a taxable event to the bankruptcy estate, requiring the estate to recognize the gain inherent in the property at the time of abandonment for tax purposes, is unfair to the taxing authority because it converts what would otherwise be a nondischargeable debt into a dischargeable one, making it less likely

185. See *Olson*, 930 F.2d at 8; *Terjen*, 154 B.R. at 459.

186. Recall that the Commercial Law League's empirical study estimated that over the four-year testing period of the study, nearly \$340 million would have been available to unsecured creditors in the absence of trustee abandonments. Moreover, this number was "exclusive of the potential capital gain taxes and the obligations owed to the creditors secured by the assets." Commercial Law League of Am., *supra* note 24, at 21.

187. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994).

188. *Id.* §§ 601-610, 108 Stat. at 4147-50.

189. 1 NAT'L BANKR. REVIEW COMM'N, *supra* note 156, at 943-80.

190. *Id.* at 970. For a more comprehensive discussion of the treatment of tax attributes in bankruptcy, see *infra* notes 268-76 and accompanying text.

that the taxing authority will ever recover its claim in full.¹⁹¹ The Commission reasoned that, if the debtor had sold or otherwise disposed of the property just before bankruptcy, he would have triggered the gain inherent in the property, and the resulting tax liability would have been a nondischargeable tax in the debtor's ensuing bankruptcy proceeding.¹⁹²

Adopting a proposal first suggested by the ABA Task Force, the Commission proposed that when a trustee abandons property to the debtor during the administration of a bankruptcy proceeding, the abandonment should be treated as a disposition of the property by the debtor immediately before bankruptcy.¹⁹³ Thus, the tax liability resulting from the disposition would be a prepetition debt and could be satisfied, at least in part, out of assets in the bankruptcy estate. Any remaining tax liability would be a nondischargeable tax and would be the debtor's responsibility. The Commission's proposal also provided that the debtor's personal tax liability would not arise until he had actually disposed of the property, either during or after the bankruptcy proceeding.¹⁹⁴ In support of its proposal, the Commission argued that the proposal was fair to both the debtor and the taxing authority, because "[t]he debtor will have a nondischargeable tax liability, the same as if he had disposed of the asset immediately prior to bankruptcy, and will not have beaten the system by having the

191. 1 NAT'L BANKR. REVIEW COMM'N, *supra* note 156, at 970. The report recognized that the tax liability would be treated as a first priority administrative expense in the debtor's bankruptcy proceeding. *See id.*

192. *Id.*; *see also* 11 U.S.C. §§ 507(a)(8)(A)(i), 523(a)(1) (2000).

193. 1 NAT'L BANKR. REVIEW COMM'N, *supra* note 156, at 970. It should be noted that, although the Commission ultimately adopted the proposal outlined in the text, it also proffered two contrary proposals that had received some support by the Commission during its deliberation process. The first contrary proposal was to clarify statutorily the position adopted by a majority of courts that an abandonment was not a transfer for tax purposes, thereby shifting the tax liability inherent in the abandoned property from the estate to the debtor. *See id.* at 970–71. Proponents of this proposal recognized that the proposal would have the effect of burdening the debtor's fresh start, but argued that shifting the tax burden from the estate to the debtor protected creditors, who received no benefit from the property and who would otherwise be subsidizing the debtor's fresh start. *Id.* at 971.

The Commission's second alternative proposal also proposed codifying the majority rule that an abandonment was not a taxable event, but added that any tax attributes clearly traceable to the abandoned property should be transferred with the abandoned property back to the debtor. *See id.* at 971–72. The proposal argued that allowing the debtor the benefit of tax attributes associated with the abandoned property "alleviates the inequity associated with the majority rule." *Id.* at 972.

194. *Id.* at 970.

gain treated as an administrative expense.¹⁹⁵

Like the Commercial Law League proposal, the Commission's proposal raises two major policy concerns. First, it fails to acknowledge that nearly ninety percent of all chapter 7 consumer bankruptcy cases are so-called no-asset cases.¹⁹⁶ In these cases, after (i) secured creditors receive encumbered assets on which they hold a valid and unavoidable security interest,¹⁹⁷ and (ii) the debtor receives assets on which she has claimed a valid exemption,¹⁹⁸ there are no assets remaining for distribution to unsecured creditors, including priority creditors.¹⁹⁹ Accordingly, in the vast majority of chapter 7 cases, none of the tax liability arising out of the Commission's proposed "disposition by the debtor immediately prior to bankruptcy"²⁰⁰ will be satisfied out of the bankruptcy estate. Thus, the entire tax burden will fall on the debtor, who will possess no tax attributes against which to offset the liability because the attributes will have all been transferred to the bankruptcy estate at the commencement of the case.²⁰¹

Moreover, the debtor will be burdened with a tremendous tax liability without having funds available to pay that liability. As discussed previously, it is a fundamental notion of tax law that the Tax Code attempts, whenever possible, to match the imposition of tax with the receipt of funds with which to pay that

195. *Id.*

196. See TERESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 203 (1989). Other studies confirm this 90% figure. See, e.g., Irving A. Breitowitz, *New Developments in Consumer Bankruptcies: Chapter 7 Dismissal on the Basis of "Substantial Abuse"* (pt. 1), 59 AM. BANKR. L.J. 327, 335 (1985) ("[F]or all practical purposes, the priority and distribution provisions of chapter 7 are virtually a dead letter since, in over 90% of all cases, there are no assets available for distribution after exemptions are claimed."). Another study found that over 92% of chapter 7 proceedings were "no asset" cases. Herbert & Pacitti, *supra* note 25, at 311. For an in-depth critique of the Sullivan study, see Karen Gross, *Re-Vision of the Bankruptcy System: New Images of Individual Debtors*, 88 MICH. L. REV. 1506 (1990) (reviewing SULLIVAN ET AL., *supra*).

197. See 11 U.S.C. § 506 (2000) (governing secured claims in bankruptcy generally); see also *id.* § 522(f) (governing the avoidance of security interests under certain proscribed circumstances).

198. See *id.* § 522. For a more comprehensive discussion of the exemption process, see Michelle Arnpol Cecil, *Crumbs for Oliver Twist: Resolving the Conflict Between Tax and Support Claims in Bankruptcy*, 20 VA. TAX REV. 719, 733-35 (2001).

199. See Cecil, *supra* note 198, at 767.

200. 1 NAT'L BANKR. REVIEW COMM'N, *supra* note 156, at 970.

201. See I.R.C. § 1398(g) (2000); see also *infra* notes 268-76 and accompanying text (discussing the operation of I.R.C. § 1398(g) in a bankruptcy proceeding).

tax liability.²⁰² Although the Commission's proposal attempts to address this issue by not imposing tax liability on the debtor until he sells or otherwise disposes of the property after the trustee has abandoned it to him, the proposal fails to recognize that most such dispositions will be the result of a foreclosure on the property by a secured creditor.²⁰³ In foreclosure cases, the debtor rarely, if ever, receives any cash upon the consummation of the foreclosure sale. Yet the Commission's proposal would nevertheless impose a tax burden on the debtor at the time of the foreclosure sale, with no realistic means available to the debtor with which to pay the liability. For these reasons, the National Bankruptcy Review Commission's proposal does not offer a viable alternative for addressing the problem of how to tax abandonments in bankruptcy.

C. THE NATIONAL BANKRUPTCY CONFERENCE PROJECT

A decade after the Bankruptcy Code was enacted in 1978, the National Bankruptcy Conference²⁰⁴ undertook a comprehensive review of how the new law was operating in practice.²⁰⁵ Six years later, in 1994, the Conference released its final report, which concluded that although the structure and operation of the Bankruptcy Code were sound overall, a number of bankruptcy provisions were in need of substantial revision.²⁰⁶ One such proposed revision related to the tax consequences of abandonment in an individual chapter 7 or 11 bankruptcy proceeding.²⁰⁷

The Conference's report first recognized that a savvy debtor

202. See *supra* note 149 and accompanying text.

203. See, e.g., *Samore v. Olson* (*In re Olson*), 930 F.2d 6, 7–8 (8th Cir. 1991) (per curiam); *Terjen v. Santoro* (*In re Terjen*), 154 B.R. 456, 457–58 (E.D. Va. 1993), *aff'd*, 30 F.3d 131 (4th Cir. 1994) (unpublished table opinion); *In re Burpo*, 148 B.R. 918, 919 (Bankr. W.D. Mo. 1993); *In re A.J. Lane & Co.*, 133 B.R. 264, 266–67 (Bankr. D. Mass. 1991). For a more comprehensive discussion of the facts underlying these cases, see *supra* notes 63–145 and accompanying text.

204. The National Bankruptcy Conference is a “voluntary, non-profit, self-supporting organization of about sixty lawyers, law teachers, and bankruptcy judges who have achieved scholarly distinction in the field of bankruptcy law. Its purpose is to study . . . the operation of bankruptcy and related laws and to consult with Congress . . . on needed revisions.” Lawrence P. King et al., *Foreword to NAT'L BANKR. CONFERENCE, REFORMING THE BANKRUPTCY CODE: THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT*, at I (Final Report 1994).

205. *Id.* The program was sponsored by the American Law Institute and the American Bar Association. See NAT'L BANKR. CONFERENCE, *supra* note 204, at I.

206. King et al., *supra* note 204, at II.

207. NAT'L BANKR. CONFERENCE, *supra* note 204, at 89.

could shift the tax liability inherent in appreciated property to the bankruptcy estate merely by filing a bankruptcy petition before a secured creditor foreclosed on the property.²⁰⁸ The report also recognized that a well-advised trustee could, under the majority rule, shift the tax burden back to the debtor simply by abandoning the property to the debtor before foreclosure.²⁰⁹ Arguing that the outcome of such an important tax question should not turn on which party has more sophisticated tax counsel, the report proposed that any sale, abandonment, foreclosure, or other disposition of property occurring as part of an individual chapter 7 or 11 bankruptcy proceeding should be treated as discharge of indebtedness income.²¹⁰

The Conference's proposal that taxable gain triggered upon a disposition of property that occurs as part of a bankruptcy proceeding be treated as discharge of indebtedness income has considerable merit. Unfortunately, because the Conference's final report devoted only two pages to this important topic, it left a host of questions unresolved. For example, which party will bear the burden of this discharge of indebtedness income, the debtor or the bankruptcy estate? Moreover, how will the debtor's tax attributes be allocated? Will they remain property of the bankruptcy estate even if it is the debtor who bears ultimate responsibility for the discharge of indebtedness income? Thus, although the National Bankruptcy Conference's proposal offers a positive first step toward resolving the dilemma of how to tax abandonments in bankruptcy, it does not go far enough.

D. THE WILLIAMS PROPOSAL

Professor Jack Williams, a prominent bankruptcy taxation scholar, wrote an article in 1994 addressing the tax consequences of abandonments in bankruptcy in which he built on the proposal developed earlier that year by the National Bankruptcy Confer-

208. *Id.* at 90. The report referred to such encumbered property as a "hot asset." *Id.*

209. *Id.* The report notes that, even under the majority rule, a trustee cannot wait until after the property is foreclosed upon, and then abandon the proceeds from the foreclosure sale back to the debtor. *Id.* (citing *Erickson v. United States (In re Bentley)*, 916 F.2d 431 (8th Cir. 1990)). For a discussion of this exception to the majority rule, see *supra* note 113 and accompanying text.

210. See *id.* at 89, 91. Under the proposal, the discharge of indebtedness income would be "subject to exclusion and attribute reduction." *Id.* at 91. For a more comprehensive discussion of discharge of indebtedness income generally and the attribute reduction mentioned in the Conference's proposal, see *infra* notes 243-58 and accompanying text.

ence.²¹¹ After adopting the Conference's proposal that income arising from the abandonment and subsequent foreclosure or other disposition of property during an individual debtor's chapter 7 or 11 bankruptcy proceeding should be treated as discharge of indebtedness income for tax purposes, Williams suggested that the same treatment be afforded to individual debtors in chapter 12 and 13 proceedings as well.²¹² In support of his proposal, Williams argued that the tax burden imposed on the debtor was the same under each chapter and that the debtor's fresh start policy was equally important in all four types of bankruptcy proceedings.²¹³ Moreover, Williams posited that both bankruptcy and tax policy favor minimizing the influence that tax law has on a debtor's selection of the appropriate bankruptcy chapter under which to seek relief. "By restricting favorable section 108 [discharge of indebtedness] treatment to chapter 7 or 11 cases, the Conference report conflicts with this policy."²¹⁴

Williams also proposed that the Conference proposal be modified to include insolvent taxpayers who had not filed for bankruptcy protection, and offered two arguments in support of this expansion. First, Williams argued that under current law, special provisions that allow a taxpayer to exclude discharge of indebtedness income from the taxpayer's gross income apply equally to insolvent and bankrupt debtors.²¹⁵ Second, without a provision allowing insolvent taxpayers to take advantage of this exception, many of those taxpayers will be forced to file for bankruptcy protection for tax purposes, in violation of traditional tax law notions of horizontal equity.²¹⁶

Finally, Williams recognized that the Conference proposal failed to address whether it was the debtor or the bankruptcy estate who was responsible for the discharge of indebtedness income arising out of the sale or disposition of an appreciated asset

211. See Williams, *supra* note 58, at 55–65.

212. *Id.* at 59–60.

213. *Id.* at 59.

214. *Id.* at 60.

215. See *id.*; see also I.R.C. § 108 (2000) (describing discharge of indebtedness income).

216. Williams, *supra* note 58, at 64. Horizontal equity is satisfied if taxpayers in equal positions are treated equally. 1 RICHARD A. MUSGRAVE, *ET, OT and SBT*, in PUBLIC FINANCE IN A DEMOCRATIC SOCIETY 260, 260–61 (1986); see also S. REP. NO. 99-313, at 4 (1986) (discussing fairness in a tax system); Stuart Rosow, *The Treasury's Reform Proposals: Not a Fair Tax*, 3 YALE L. & POL'Y REV. 58, 61 (1984) (same).

during the bankruptcy proceeding.²¹⁷ He concluded that if the disposition, such as a foreclosure, occurred while the asset was still property of the bankruptcy estate, then it should be the estate that would bear the burden of the discharge of indebtedness income. Conversely, Williams concluded that if the disposition occurred after abandonment, when the debtor owned the property, then it should be the debtor who would bear the tax burden of the discharge of indebtedness income.²¹⁸ In reaching this determination, Williams adopted the majority view that the trustee's abandonment of property to the debtor was not a taxable transfer.²¹⁹ To alleviate the problem that the debtor would have discharge of indebtedness income without the corresponding tax attributes against which to offset that income, Williams proposed that the tax attributes that could clearly be associated with the abandoned property be transferred from the estate to the debtor at the time of the abandonment.²²⁰

217. Williams, *supra* note 58, at 60.

218. *See id.* at 61.

219. *See id.* In support of this position, Williams argued the following:

Bankruptcy abandonment is not an exchange or disposition for tax purposes; rather, bankruptcy abandonment is a disclaimer by the trustee of the estate's interest in the abandoned property. The debtor's interest in the property, which always remained in place throughout bankruptcy but was subordinate to the estate's judicial lien, becomes the dominant interest once again.

Id.

220. *See id.* Williams also suggested that, with respect to tax attributes not readily associated with a specific piece of property, the Service should propose regulations that would allocate those tax attributes in a reasonable manner so that some of those attributes transferred to the debtor with the abandoned property. *Id.* It is interesting to note that the notion that tax attributes associated with abandoned property be transferred back to the debtor upon abandonment is not new. In 1992, when the Service promulgated new regulations under section 1398 of the Tax Code, the regulations provided that when a trustee abandoned an interest in a passive activity or former passive activity to the debtor during the pendency of a bankruptcy proceeding, that abandonment should not be treated as a taxable event to the bankruptcy estate. *See* Treas. Reg. § 1.1398-1(d)(1) (1994). The regulations further provided that, in such a case, the estate must transfer to the debtor the unused passive activity loss and credit carryovers associated with the abandoned property. *See id.* § 1.1398-1(d)(2)(i). For a more comprehensive discussion of these regulations, see Richard M. Lipton, *Proposed 1398 Regulations Raise Conflict Between Debtors and Bankruptcy Trustees*, 79 J. TAX'N 12 (1993).

Williams's article also contained two other minor proposals, only one of which is relevant to the issue of taxing abandonments in bankruptcy. He suggested that when a bankruptcy trustee files a no-asset report with the court, it should be treated as an abandonment for tax purposes. *See* Williams, *supra* note 58, at 61-62. In this way, a foreclosure of the debtor's property after the no-asset report is filed will result in discharge of indebtedness income to the

Williams's suggestion that the Conference proposal be extended to debtors who have sought bankruptcy protection under chapter 12 or 13 of the Bankruptcy Code and to insolvent debtors not in bankruptcy are both well reasoned and strongly grounded in bankruptcy and tax policy. Accordingly, the proposal outlined below will borrow and build upon this idea. On the other hand, Williams's proposal regarding the transfer of certain tax attributes back to the debtor upon abandonment is too vague to be useful. This Article will propose a radically different solution to the vexing issue of how tax attributes should be allocated in a bankruptcy proceeding than any scholarly work or study that has come before.

V. UNIFYING BANKRUPTCY AND TAX POLICY: A PROPOSAL FOR CHANGE

Although each of the foregoing proposals provides useful insights into the bankruptcy abandonment issue, they fail to provide a comprehensive solution to the problem. This Article will propose a three-pronged approach to the taxation of property abandonments in a debtor's bankruptcy proceeding. First, it will argue that the debtor should bear the burden of the tax imposed on the gain inherent in an asset owned at the commencement of the bankruptcy case, whether the asset is abandoned by the trustee to the debtor, sold by the trustee for the benefit of unsecured creditors, or retained by the debtor for his fresh start.²²¹ Second, the Article will propose that, because the debtor does not have ready cash available to pay the tax on the inherent gain, the gain should be treated as discharge of indebtedness income when the debtor disposes of the asset, either through sale or foreclosure.²²² Finally, the Article will suggest that the debtor retain all tax attributes available at the time of the bankruptcy filing so that they can be used to absorb the discharge of indebtedness income arising upon the disposition of the asset.²²³

debtor, not the bankruptcy estate. *Id.* According to Williams, "[t]his modification more accurately reflects the intention and understanding of the parties involved." *Id.* at 63.

221. See *infra* notes 224–30 and accompanying text.

222. This proposal, including a comprehensive explanation of the concept of cancellation of indebtedness income, is discussed in greater detail *infra* notes 231–67 and accompanying text.

223. See *infra* notes 268–78 and accompanying text.

A. IMPOSING THE TAX BURDEN ON THE DEBTOR

As discussed earlier, traditional tax policy notions suggest that the taxpayer who has enjoyed the benefits of a property's appreciation in value should bear the burden of paying the tax on that appreciation.²²⁴ In a bankruptcy proceeding, it is the debtor, not the bankruptcy estate, who has enjoyed the benefits of the pre-bankruptcy appreciation inherent in her assets, through the use and enjoyment of those assets and the ability to use those assets as collateral for a loan.²²⁵ Accordingly, tax policy dictates that the debtor should bear the burden for the tax imposed on the pre-bankruptcy appreciation of her assets, irrespective of whether the property is abandoned to the debtor because it is of inconsequential value to the estate, sold by the trustee for the benefit of unsecured creditors, or retained by the debtor as exempt property necessary for her fresh start.

Because tax policy dictates that the debtor, rather than the bankruptcy estate, should bear the burden of any tax imposed on the pre-petition appreciation inherent in an asset, it follows logically that the trustee's abandonment of the asset to the debtor during the bankruptcy proceeding should not constitute a taxable event. Thus, although *A.J. Lane* reached the correct conclusion from a statutory construction standpoint that an abandonment by the trustee is taxable to the bankruptcy estate,²²⁶ *Olson* and its progeny had the better-reasoned argument from a policy perspective.²²⁷ Accordingly, both the Bankruptcy Code and the Tax Code must be amended to reflect the view that a property abandonment during a bankruptcy proceeding will not be taxable transfer, and thus will not result in any taxable gain to the bankruptcy estate.

Moreover, because tax policy attempts to match the imposition of a tax with the taxpayer's ability to pay it,²²⁸ the debtor's

224. See, e.g., 1 NAT'L BANKR. REVIEW COMM'N, *supra* note 156, at 971.

225. See *id.* For example, the taxpayer might use the proceeds of a loan secured by the appreciated property to purchase a yacht or to go on an exotic vacation, thereby enjoying the benefits of the property's increase in value currently. Moreover, the taxpayer might use the proceeds of such a loan to add an addition to an apartment building, thereby generating increased depreciation deductions annually and reducing the taxpayer's taxable income by a corresponding amount.

226. For a more complete discussion of the *A.J. Lane* case, see *supra* notes 63-99 and accompanying text.

227. See *supra* notes 114-43 and accompanying text.

228. See OLIVER & PEEL, JR., *supra* note 149, at 50; U.S. DEPT OF THE TREASURY, *supra* note 149, at 81.

tax liability for pre-bankruptcy appreciation should not arise until a realization event occurs upon a sale or other disposition of the property.²²⁹ For example, the trustee's sale of the property for the benefit of the estate will trigger the debtor's tax liability. Similarly, if the property reverts back to the debtor upon abandonment by the trustee or is retained by the debtor as exempt property necessary for his fresh start,²³⁰ the debtor's tax liability will not arise until the debtor sells the property to pay his secured creditors or the property is foreclosed upon by the creditor upon the debtor's default.

B. TREATING THE RESULTING GAIN AS DISCHARGE OF INDEBTEDNESS INCOME

The problem with imposing a tax on the debtor upon the property's sale or other disposition is that the debtor is clearly in a state of financial distress and may not have ready cash available to pay the tax, especially if the realization event occurs upon the property's foreclosure by a secured creditor²³¹ or the trustee's sale of the property for the benefit of the estate. Accordingly, this Article builds on the suggestion first proposed by the National Bankruptcy Conference in 1994 that the tax liability resulting from an asset's pre-bankruptcy appreciation be treated as discharge of indebtedness income to the debtor.²³² This Article's pro-

229. See I.R.C. § 1001(a) (2000).

230. See H.R. REP. NO. 95-595, at 125 (1977), *reprinted in* 1978 U.S.C.A.N. 5963, 6086 ("The two most important aspects of the fresh start available under the Bankruptcy laws are the provision of adequate property for a return to normal life, and the discharge . . ."). A debtor is generally entitled to select either the exemptions of the state in which he resides (together with exemptions established under federal nonbankruptcy laws and joint tenancy and tenancy by the entirety property exempt from the reach of creditors under nonbankruptcy law), see 11 U.S.C. § 522(b)(1), (2) (2000), or the federal exemptions set forth in section 522(d) of the Bankruptcy Code, whichever is more generous. States may, however, opt out of the federal bankruptcy exemption scheme, in which case the debtor must use the exemptions provided under the laws of the debtor's state of residence. See *id.* § 522(b)(1).

231. In fact, case law suggests that most property dispositions in the bankruptcy context that occur after the bankruptcy trustee has abandoned secured property to the debtor are the result of a foreclosure on the property by a secured creditor. See, e.g., *Samore v. Olson (In re Olson)*, 930 F.2d 6, 7 (8th Cir. 1991) (per curiam); *Terjen v. Santoro (In re Terjen)*, 154 B.R. 456 (E.D. Va. 1993), *aff'd*, 30 F.3d 131 (4th Cir. 1994) (unpublished table decision); see also *supra* notes 63-145 and accompanying text.

232. See NAT'L BANKR. CONFERENCE, *supra* note 204, at 89-91. Although the National Bankruptcy Conference proposed that gain resulting from the disposition of property in a proceeding be treated as discharge of indebtedness income, it failed to resolve whether the debtor or bankruptcy estate should bear the bur-

posal, however, goes much further than any proposal that has come before, because it applies even in cases in which the trustee sells an asset that is part of the bankruptcy estate for the benefit of unsecured creditors rather than abandoning the property to the debtor or another party with a possessory interest in the property. As discussed previously, current law provides that if the bankruptcy trustee sells appreciated property that is part of the estate, it is the estate, and not the debtor, that must include the built-in gain inherent in the property in the estate's gross income.²³³ This Article takes the position that even if the trustee sells appreciated property for the benefit of unsecured creditors, the debtor should nonetheless bear the burden of the tax on the appreciation inherent in the property because again it was the debtor, and not the unsecured creditors, who enjoyed the pre-bankruptcy benefits of that appreciation. To find otherwise could lead to incongruous results. For example, under current law if the trustee abandons encumbered property back to the debtor, and that property is later foreclosed upon by the secured creditor to satisfy its claim, it is the debtor who is responsible for the tax on the gain inherent in that property.²³⁴ Conversely, if the trustee sells unencumbered property with the same amount of appreciation for the benefit of unsecured creditors, it is the estate, and not the debtor, that is responsible for the tax on the same gain.²³⁵ Shifting the tax burden from the debtor to the estate simply because the debtor's creditors hold unsecured rather than secured claims elevates form over substance.²³⁶ From a policy perspective, the debtor should bear the tax burden in both situations because the debtor enjoyed the benefit of the property's appreciation in both instances.

Moreover, although a separate taxable entity is created under the Tax Code only in individual chapter 7 and 11 bankruptcy cases, this Article adopts the suggestion first espoused by Professor Williams that this discharge of indebtedness treatment apply

den of that tax. *See supra* note 217 and accompanying text.

233. *See* S. REP. NO. 95-989, at 66 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5852; *see also supra* notes 57-58 and accompanying text.

234. *See, e.g., Olson*, 930 F.2d at 8.

235. *See supra* note 57 and accompanying text.

236. Professor Williams's abandonment proposal adopted this very concept. He proposed that the estate should bear the burden of the discharge of indebtedness income if the asset was sold or disposed of while still property of the estate, but the debtor should bear the tax burden if instead the disposition occurred after abandonment, while the debtor owned the property. *See Williams, supra* note 58, at 61; *see also supra* notes 217-20 and accompanying text.

equally to debtors in chapter 12 and 13 bankruptcy proceedings,²³⁷ as well as to debtors who are insolvent but have not availed themselves of bankruptcy protection.²³⁸ As to the suggestion that this favorable tax treatment should apply to debtors filing chapter 12 and 13 bankruptcy petitions, Williams aptly argued that the fresh start policy is equally strong in all four types of bankruptcy proceedings.²³⁹ Williams also suggested that “both bankruptcy and tax law recognize a strong policy to minimize the influence of tax consequences in selecting under which chapter an individual debtor seeks relief.”²⁴⁰ To allow a debtor to avail himself of the discharge of indebtedness rules only in chapter 7 or 11 defeats this well-established policy. Moreover, this discharge of indebtedness treatment should apply equally to corporations and individuals seeking protection under the Bankruptcy Code.

Additionally, discharge of indebtedness treatment should also be expanded to encompass insolvent debtors not in bankruptcy for two reasons. First, as Williams argued, if this tax treatment is applicable only in bankruptcy, taxpayers might be forced to file for bankruptcy protection merely for tax purposes, which violates traditional tax notions of horizontal equity.²⁴¹ It also places an additional strain on the nation’s already overburdened bankruptcy courts. Second, current discharge of indebtedness rules already apply equally to both insolvent debtors and those in bankruptcy.²⁴²

As discussed in more detail below, treating the gain resulting from the sale or disposition of an asset as discharge of indebtedness income will result in no immediate tax liability to the debtor, thereby furthering the bankruptcy policy of preserving the debtor’s fresh start. Instead, the tax burden will be postponed un-

237. See *supra* notes 212–14 and accompanying text. Recall that, although the abandonment issue arises only in individual chapter 7 and 11 cases, where the bankruptcy estate is a separate taxable entity, see I.R.C. §§ 1398, 1399 (2000), this Article’s solution is far more expansive, and covers situations in which the trustee in fact sells an asset in the bankruptcy estate for the benefit of unsecured creditors rather than abandoning it to the debtor.

238. See *supra* notes 215–16 and accompanying text.

239. Williams, *supra* note 58, at 59.

240. *Id.* at 59–60.

241. See *supra* note 216 and accompanying text; see also 2 FRANK R. KENNEDY ET AL., KENNEDY, COUNTRYMAN & WILLIAMS ON PARTNERSHIPS, LIMITED LIABILITY ENTITIES AND S CORPORATIONS IN BANKRUPTCY § 13.02, at 13-5 (2000) (“For purposes of bankruptcy taxation, it [horizontal equity] would seem to mean that nonbankruptcy insolvent taxpayers should generally receive treatment similar to that of insolvent title 11 taxpayers.”).

242. See I.R.C. § 108 (2000); see also Williams, *supra* note 58, at 60.

til the debtor is better able to meet that tax obligation in the future.

1. A Primer on the Discharge of Indebtedness Rules²⁴³

Section 61 of the Tax Code requires a taxpayer to include in gross income "income from whatever source derived."²⁴⁴ The Supreme Court has stated that gross income includes any accession to the taxpayer's wealth.²⁴⁵ When a taxpayer borrows money, the loan proceeds are not considered gross income because the taxpayer acquires a corresponding obligation to repay the borrowed money and, thus, does not have an accession to wealth.²⁴⁶ If, however, the taxpayer is relieved of the obligation to repay the borrowed funds, then the taxpayer must include the discharged debt in her gross income.²⁴⁷ This concept, referred to alternatively as cancellation of indebtedness income or discharge of indebtedness income, was first recognized in the landmark 1931 Supreme Court case of *United States v. Kirby Lumber Co.*²⁴⁸ The policy justification for including discharge of indebtedness in gross income

243. Much of this subsection was taken from Cecil, *supra* note 146, at 1006-07.

244. I.R.C. § 61(a) (2000).

245. *See* *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (noting that gross income includes all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").

246. *See* *United States v. Rochelle*, 384 F.2d 748, 751 (5th Cir. 1967) ("A loan does not in itself constitute income to the borrower, because whatever temporary economic benefit he derives from the use of the funds is offset by the corresponding obligation to repay them."); *see also* *Comm'r v. Wilcox*, 327 U.S. 404, 408 (1946); *Minnis v. Comm'r*, 71 T.C. 1049, 1056 (1979); *Stayton v. Comm'r*, 32 B.T.A. 940, 943 (1935).

247. *See* *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931).

248. *Id.* In *Kirby Lumber*, Kirby Lumber issued its own bonds for approximately \$12 million and received par value on the sale of the bonds. *Id.* at 2. Because of a decline in the value of the bonds later that year, Kirby Lumber repurchased some of the bonds for less than par value, with a price differential of approximately \$137,000. *Id.* The Commissioner sought to tax Kirby Lumber on the \$137,000 amount as an accession to Kirby Lumber's gross income for the year. *See id.* Justice Holmes, writing the opinion for the Court, agreed with the Commissioner, holding that, as a result of the transaction, Kirby Lumber suffered no reduction in its assets and recognized a clear gain. "As a result of its dealings it made available \$137,521.30 assets previously offset by the obligation of bonds now extinct . . . [Kirby Lumber] has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here." *Id.* at 3; *see also* *Haden Co. v. Comm'r*, 118 F.2d 285, 286 (5th Cir. 1941) ("Assets to the extent of \$116,906.54, previously offset by liabilities, were freed from the claims of creditors, and to this extent the petitioner thereby 'realized within the year an accession to income.'" (quoting *Kirby Lumber*, 284 U.S. at 3)).

enunciated by Justice Holmes in *Kirby Lumber* was that the taxpayer experienced an increase in its net worth when its assets were freed up as a result of extinguishing its liabilities at a discount.²⁴⁹ Although *Kirby Lumber's* theoretical underpinnings have been challenged by tax scholars,²⁵⁰ this net worth approach is consistent with traditional notions of a comprehensive income tax base,²⁵¹ and the concept of including discharges of indebtedness in gross income is now clearly embedded in the income tax system.²⁵²

The Tax Code offers an exception to the harsh tax consequences of this rule under certain limited circumstances. Section 108(a) of the Code provides that gross income of a taxpayer does not include any amount that otherwise would be discharge of indebtedness income to the taxpayer if the debt discharge occurs either (i) in a title 11 bankruptcy proceeding,²⁵³ or (ii) while the

249. *Kirby Lumber*, 284 U.S. at 3. Commentators have often referred to this policy justification as the balance sheet approach. See, e.g., Peter C. Canellos, *Rethinking the Tax Aspects of Debt Restructuring*, 70 TAXES 808, 810 (1992); Katherine Pratt, *Shifting Biases: Troubled Company Debt Restructurings After the 1993 Tax Act*, 68 AM. BANKR. L.J. 23, 26 (1994).

250. See 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) (arguing that cancellation of debt income, sometimes referred to as COD income, can be justified not under a net worth or freeing of assets approach, but rather under a tax benefit theory). “[B]orrowed funds are excluded from gross income when received because of the assumption that they will be repaid in full . . . a tax adjustment is required when this assumption proves erroneous.” *Id.* at 1165 (citing to cases discussing the tax benefit theory); see also Theodore P. Seto, *The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System*, 51 TAX L. REV. 199, 201–06 (1996) (noting that the Supreme Court has recently adopted both the net worth theory and the tax benefit rationale for COD income in *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 582 (1991)). For a more complete discussion of the impact of *Centennial* on the policy underlying COD income, see Paul J. Sax, *Supreme Court Decides Fundamental Debt Discharge, Loss Realization Issues*, 75 J. TAX’N 54, 54–56 (1991).

251. For a more detailed discussion of the concept of a comprehensive income tax base, see *supra* notes 154–56 and accompanying text.

252. See, e.g., Patricia L. Bryan, *Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps*, 63 TEX. L. REV. 89, 96 (1984) (“Although the Court’s analysis in *Kirby Lumber* . . . has been criticized by commentators, the correctness of the result has rarely been doubted.” (footnotes omitted)).

253. A taxpayer is entitled to rely on the title 11 exception only if the taxpayer is under the jurisdiction of a bankruptcy court in a case commenced under title 11 of the United States Code, and “the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.” I.R.C. § 108(d)(2) (2000).

taxpayer is insolvent.²⁵⁴ The legislative history of the Bankruptcy Tax Act of 1980 provides that the policy justification for this rule is to “preserve the debtor’s ‘fresh start’ after bankruptcy . . . so that a debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability.”²⁵⁵

There is, however, a toll charge exacted from these bankruptcy and insolvent taxpayers, codified in section 108(b) of the Code. Section 108(b) provides that the amount excluded from a taxpayer’s gross income by reason of section 108(a) must be applied to reduce the taxpayer’s tax attributes in the following order: net operating losses,²⁵⁶ general business credits, minimum

254. *Id.* § 108(a)(1). That provision states:

(1) In general

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

- (A) the discharge occurs in a title 11 case,
- (B) the discharge occurs when the taxpayer is insolvent,
- (C) the indebtedness discharged is qualified farm indebtedness, or
- (D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Id. It should be noted that if this gross income exclusion applies by reason of the taxpayer’s insolvency, § 108(a)(3) provides that the exclusion will only apply to the extent that the taxpayer is insolvent. *Id.* § 108(a)(3). Moreover, insolvency is defined in § 108(d)(3) as “the excess of liabilities over the fair market value of assets.” *Id.* § 108(d)(3). The determination of insolvency is made by looking at the taxpayer’s assets and liabilities just prior to the debt discharge. *Id.*

One issue that continues to perplex the courts is whether contingent liabilities, such as guarantees, should count as liabilities for purposes of determining insolvency under I.R.C. § 108(d)(3). In a recent case, *Merkel v. Commissioner*, 109 T.C. 463 (1997), the Tax Court held that only those liabilities that the taxpayer is likely to be called upon to pay (under a “more probable than not” standard) would affect the determination of insolvency under section 108(d)(3) of the Code. *See id.* at 484. For a more comprehensive discussion of this issue, see Celia R. Clark, *COD Income: New Opportunities for Insolvency Planning After Merkel*, 89 J. TAX’N 29 (1998); see also Pratt, *supra* note 249, at 28 & n.29.

255. S. REP. NO. 96-1035, at 10 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7025; H.R. REP. NO. 96-833, at 9 (1980).

256. Net operating losses, frequently referred to as NOLs, are often the most valuable assets of a financially troubled corporation because they can shelter its income from federal income taxes when it emerges from bankruptcy. For a more comprehensive discussion of the value of NOLs generally, see Arnopol, *supra* note 69, at 138–39; see also Valerie E. Burke & Gardner F. Davis, *The Forgotten Asset: Net Operating Losses of the Chapter 11 Corporate Debtor*, FLA. B.J., Mar. 1994, at 69, 69 (1994).

tax credits, capital loss carryovers, the basis of the taxpayer's property, passive activity loss and credit carryovers, and foreign tax credit carryovers.²⁵⁷ The Senate Finance Committee explained

257. I.R.C. § 108(b) (2000). That section provides in pertinent part:

(b) Reduction of Tax Attributes

(1) In general

The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) Tax attributes affected; order of reduction

Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) NOL

Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) General business credit

Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) Minimum tax credit

The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) Capital loss carryovers

Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

(E) Basis reduction

(i) In general

The basis of the property of the taxpayer.

(ii) Cross reference

For provisions for making the reduction described in clause (i), see section 1017.

(F) Passive activity loss and credit carryovers

Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.

(G) Foreign tax credit carryovers

Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

(3) Amount of reduction

(A) In general

Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).

(B) Credit carryover reduction

that the policy underlying these attribute reduction rules is to allow financially distressed debtors to defer including in gross income the income that they realize from discharge of indebtedness, but not to allow them to exclude such amounts from income forever. "[T]he rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a

The reductions described in subparagraphs (B), (C), and (G) shall be 33 1/3 cents for each dollar excluded by subsection (a). The reduction described in subparagraph (F) in any passive activity credit carryover shall be 33 1/3 cents for each dollar excluded by subsection (a).

Id.

If a taxpayer is required to reduce the basis in her property under § 108(b)(2)(E), the basis reduction is capped at the amount by which the adjusted basis of the taxpayer's assets exceeds the aggregate amount of her liabilities immediately after the debt discharge. See *id.* § 1017(b)(2). For an in-depth examination of these tax attribute reduction rules, including the basis reduction limitation, see Paul H. Asofsky, *Discharge of Indebtedness Income in Bankruptcy After the Bankruptcy Tax Act of 1980*, 27 ST. LOUIS U. L.J. 583, 587-600 (1983); see also Karrie Bercik, *The Tax Consequences of Stock-for-Debt Exchanges*, 11 J.L. & COM. 201, 206-09 (1992).

Alternatively, under § 108(b)(5), a taxpayer can forego reducing her tax attributes in the prescribed order and instead elect to reduce the basis of her depreciable property. I.R.C. § 108(b)(5). A taxpayer might choose to make such an election when, for example, she plans to use her net operating losses in the near future and preserving the net operating losses would be more beneficial on an after-tax basis than a reduction in the basis of depreciable property, which would have the effect of reducing overall depreciation deductions over an extended period of time. If a taxpayer makes this depreciable property election, the basis limitation of § 1017(b)(2) described in the preceding paragraph does not apply. See I.R.C. § 1017(b)(2). For a more extensive discussion of the § 108(b)(5) election, see THOMAS J. CARROLL ET AL., TAX ASPECTS OF BANKRUPTCY ¶ 4.4 (1992). In the case of both the basis reduction required by § 108(b)(2)(E) and the alternative depreciable basis election of § 108(b)(5), regulations have recently been promulgated in final form prescribing the order in which the basis of the taxpayer's assets must be reduced. For example, the regulations provide that, in the case of the § 108(b)(2)(E) basis reduction, the taxpayer must first reduce the basis in his real property held for investment or used in his trade or business, to the extent that such property secured the discharged indebtedness. The basis of similar personal property is next reduced, and so on. See Treas. Reg. § 1.1017-1(a) (as amended in 1999). For a more complete discussion of these complicated new regulations, see Harry C. Steinmetz & William Morris, *Bankruptcy and Insolvency Tax Developments of 1998: A Look Back*, AM. BANKR. INST. J., Mar. 1999, at 10, WL 18-MAR AMBKRIJ 10.

Finally, it is important to note that if the debtor corporation has none of the tax attributes enumerated in § 108(b)(2) and does not make the depreciable basis election of § 108(b)(5), there are no tax consequences to the debtor's discharge of indebtedness. It is not included in the debtor's gross income, nor does it carry over to future years to reduce tax attributes in those years.

reasonable period, tax on ordinary income realized from debt discharge.²⁵⁸

2. Application of the Discharge of Indebtedness Rules to Bankruptcy Abandonments

To illustrate the application of these complex rules to a typical case in which the trustee abandons encumbered property to the debtor because it is burdensome to the bankruptcy estate, consider the following example. Assume that the debtor files for bankruptcy protection under chapter 7 of the Bankruptcy Code. At the time of filing, the debtor owns an apartment complex worth \$800,000, which has an adjusted basis for tax purposes of \$300,000. The debtor originally purchased the complex for \$800,000, but has been depreciating it for a number of years, thereby reducing the property's basis to \$300,000.²⁵⁹ Thus, the property has \$500,000 of built-in gain as of the filing of the bankruptcy petition. Because all of the gain inherent in the complex is due to previously taken depreciation deductions, the \$500,000 gain will be taxed at a rate of twenty-five percent when the property is sold or otherwise disposed of,²⁶⁰ yielding a tax liability of \$125,000. Assume further that the complex is subject to a nonrecourse mortgage of \$700,000.

If the trustee sells the property for its fair market value of \$800,000, the proceeds must first be used to pay off the secured creditor's \$700,000 claim. The estate would also face a tax liability of \$125,000 on the sale, which of course would not only yield no benefit to the unsecured creditors, but would in fact cost the estate \$25,000 more than the proceeds from the sale of the complex. Thus, the trustee's proper course of action should be to abandon the apartment complex to the debtor as burdensome to the bankruptcy estate.²⁶¹ Under this Article's proposal, this aban-

258. S. REP. NO. 96-1035, at 10; H.R. REP. NO. 96-833, at 9. This same policy justification was reiterated in 1993, when, as part of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226, 107 Stat. 312, 488 (1993), Congress added minimum tax credits and passive activity loss and credit carryovers to the list of tax attributes to be reduced by the debtor's discharge of indebtedness. *Id.*

259. Depreciation deductions are considered a recoupment of the taxpayer's investment, and therefore reduce the adjusted basis of the taxpayer's property. See I.R.C. § 1016 (2000).

260. The gain is considered unrecaptured § 1250 gain, and is taxed at a rate of 25% for all taxpayers above the 15% tax bracket. See *id.* § 1(h)(1)(D), (7)(A); see also BITTKER ET AL., *supra* note 49, ¶ 31.02[2][a], at 31-8.

261. See 11 U.S.C. § 554 (2000); see also *supra* notes 30-37 and accompany-

donment would not be a taxable event to the estate.²⁶²

After the complex reverts in the debtor, he is still liable for the \$700,000 mortgage on it, and is considered to be in default on the mortgage because bankruptcy accelerates all liabilities.²⁶³ Accordingly, the debtor can either sell the complex to satisfy the mortgage or the secured creditor will foreclose on the property to satisfy its liability.²⁶⁴ A sale or foreclosure of the complex is a realization event, resulting in \$500,000 of discharge of indebtedness income to the debtor. Under the Tax Code's complicated discharge of indebtedness provisions, the debtor will not be required to pay tax on this discharge of indebtedness income immediately because he is under the jurisdiction of a bankruptcy court in a chapter 7 proceeding.²⁶⁵ The debtor will, however, be required to reduce his tax attributes, beginning with his net operating losses, by this \$500,000 amount.²⁶⁶ If he does not have \$500,000 in tax attributes, any remaining discharge of indebtedness amount will simply disappear without any further adverse tax consequences to the debtor.

The obvious benefit to this tax treatment from the debtor's perspective is that he is not faced with an immediate tax liability without the corresponding assets available to pay that liability. Yet from the government's perspective, the tax liability is not forgiven, but merely deferred until a time when the debtor is better

ing text.

262. See *supra* notes 226–27 and accompanying text.

263. See 11 U.S.C. § 101(5)(A) (2000) (defining a claim as a “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, *unmatured*, disputed, undisputed, legal, equitable, secured or unsecured” (emphasis added)).

264. The debtor has the option of reaffirming his debt with the secured creditor and retaining the property if the creditor agrees to such a reaffirmation agreement. See *id.* § 521. Reaffirmation agreements must meet a number of stringent requirements under the Bankruptcy Code. See *id.* § 524(c), (d). In a minority of jurisdictions, the debtor also has the option of retention, which allows a debtor who has remained current on all payments on a secured debt to retain the property without reaffirming the debt and simply continue to make payments on that liability. See, e.g., *McClellan Fed. Credit Union v. Parker (In re Parker)*, 139 F.3d 668, 673 (9th Cir. 1998); *Capital Communications Fed. Credit Union v. Boodrow (In re Boodrow)*, 126 F.3d 43, 51–53 (2d Cir. 1997); *Home Owners Funding Corp. of Am. v. Belanger (In re Belanger)*, 962 F.2d 345, 347–49 (4th Cir. 1992); *Lowry Fed. Credit Union v. West*, 882 F.2d 1543, 1547 (10th Cir. 1989).

265. See I.R.C. § 108(a)(1)(A) (2000); see also *supra* notes 253–55 and accompanying text.

266. See I.R.C. § 108(b) (2000). For a more detailed explanation of this tax attribute reduction rule, see *supra* notes 256–58 and accompanying text.

able to pay it. As a simplistic example, assume that the debtor had accumulated \$500,000 of net operating losses prior to bankruptcy. The debtor's \$500,000 of discharge of indebtedness income would be offset against those net operating losses, eliminating them completely. If, in a future year, the debtor earned \$800,000 in wages, he would not be able to reduce his wages by his \$500,000 of net operating losses and thus would be required to pay tax on the full \$800,000 amount. Therefore, the taxing authority would obtain its pound of flesh from the debtor by requiring him to pay tax on \$800,000 rather than \$300,000 (the wages less the debtor's net operating losses), thereby taxing the \$500,000 discharge of indebtedness income, but at a time when the debtor has the funds readily available to pay that tax. This tax treatment furthers bankruptcy policy by not burdening the debtor's fresh start with the imposition of a tax liability at a time when he is unable to satisfy that liability, while at the same time promoting sound tax policy by not allowing the appreciation inherent in an asset to go untaxed simply because a debtor avails himself of the bankruptcy system.

There is, however, one problem with the foregoing example. Under current law, the debtor does not retain his tax attributes, such as net operating losses, when he files for bankruptcy.²⁶⁷ Therefore, without a change in the law, the government would not be able to recoup the tax on discharge of indebtedness income in an abandonment situation. The following section remedies this vexing problem.

C. ALLOWING DEBTORS TO RETAIN THEIR TAX ATTRIBUTES IN BANKRUPTCY

When a debtor files for bankruptcy protection under chapter 7 or chapter 11 of the Bankruptcy Code, the bankruptcy estate succeeds to certain enumerated tax attributes of the debtor pursuant to section 1398(g) of the Tax Code.²⁶⁸ Under the statute, the

267. I.R.C. § 1398(g) (2000); *see also infra* notes 268–76 and accompanying text (discussing tax attributes of debtors in bankruptcy).

268. *See* I.R.C. § 1398(a), (g) (2000). Various “tax attributes” are defined in I.R.C. § 381. One noted bankruptcy tax scholar has argued that section 541 of the Bankruptcy Code already provides that the debtor's tax attributes transfer to the bankruptcy estate; thus, the primary purpose of section 1398 of the Tax Code is to limit the tax attributes to which the estate succeeds by enumerating only certain attributes that pass to the estate, thereby allowing the debtor to retain all remaining tax attributes for his fresh start. *See* Jack F. Williams, *The Federal Income Tax Consequences of Individual Debtor Chapter 11 Cases*, 46 S.C. L. REV. 1203, 1232–33 (1995).

enumerated attributes include four sets of tax losses and credits that the debtor was unable to utilize in previous years to offset her income tax liability in those years: net operating loss carryovers, charitable contribution carryovers, tax credit carryovers, and capital loss carryovers.²⁶⁹ The transferred attributes also include the debtor's method of accounting (usually cash or accrual),²⁷⁰ her basis and holding period in her assets, as well as the character of those assets (ordinary or capital), and any recovery of tax benefit items to which the debtor is entitled.²⁷¹ In addition,

269. See I.R.C. § 1398(g)(1), (2), (4), (5). Net operating loss carryovers are governed by I.R.C. § 172; charitable contribution carryovers are determined under I.R.C. § 170(d)(1); and capital loss carryovers are calculated under I.R.C. § 1212.

270. Although the Tax Code requires the estate to adopt the accounting method used by the debtor, there is no requirement that the estate adopt the debtor's taxable year. According to two noted bankruptcy scholars, this omission appears to be intentional, because an earlier version of § 1398 required the estate to succeed to the debtor's taxable year, but that provision was dropped in the final version of the legislation. See GRANT W. NEWTON & GILBERT D. BLOOM, *BANKRUPTCY AND INSOLVENCY TAXATION* § 4.5, at 112–13 (2d ed. 1994). Moreover, the bankruptcy estate is entitled to change its accounting period once without obtaining prior consent from the Service. I.R.C. § 1398(j)(1) (2000). For a more comprehensive discussion of this election, see 15 SHEINFELD ET AL., *supra* note 35, ¶ TX2.04[2], at TX2-23, -24.

271. See I.R.C. § 1398(g)(3), (6), (7). Section 111 of the Code establishes the extent to which a taxpayer is entitled to recover a tax benefit item. *Id.* § 111. One example of a tax benefit item to which the debtor may be entitled is a refund of state income taxes from a year prior to the year in which the debtor filed bankruptcy. See 15 SHEINFELD ET AL., *supra* note 35, ¶ TX2.04[2], at TX2-23.

The statute also authorizes the Secretary of the Treasury to establish regulations requiring that other tax attributes of the debtor be transferred to the estate upon the commencement of a bankruptcy proceeding. I.R.C. § 1398(g)(8). The legislative history to § 1398(g) provides an example, suggesting that "the regulations could allow the estate the benefit of section 1341 of the Code if the estate repays income which the debtor received under claim of right." S. REP. NO. 96-1035, at 28 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7043. The Treasury Department has not yet promulgated regulations including a debtor's claim of right as a tax attribute that transfers to the bankruptcy estate upon the commencement of the case, and courts have refused to allow the statute to be interpreted to include claim of right as a transferrable tax attribute. *DiStasio v. United States*, 22 Cl. Ct. 36, 51–52 (1990). In fact, courts have interpreted the statute quite literally to disallow the transfer of any tax attributes from the debtor to the bankruptcy estate other than those specifically enumerated in the statute or accompanying treasury regulations. See, e.g., *Rueter v. Robinson (In re Rueter)*, 158 B.R. 163, 167 (N.D. Cal. 1993) (mem.); Official Comm. of Unsecured Creditors of *D.F. Antonelli v. United States (In re Antonelli)*, 150 B.R. 364, 366–67 (Bankr. D. Md. 1992) (mem.). For an argument that nonenumerated tax attributes should become part of the debtor's bankruptcy estate, see 15 SHEINFELD ET AL., *supra* note 35, ¶ TX2.04[2], at TX2-26 to -29.

under treasury regulations promulgated in 1992, the bankruptcy estate also succeeds to the debtor's passive activity loss and credit carryovers, as well as the debtor's unused at-risk losses.²⁷² Any transfer of tax attributes from the debtor to her bankruptcy estate is deemed to occur as of the first day of the taxable year in which the debtor files for bankruptcy protection.²⁷³

This transfer of tax attributes from the debtor to her estate leads to two obvious results. First, the estate can reduce its income tax liability through its use of the debtor's loss and credit carryovers. Second, the debtor no longer has those tax attributes available to reduce her tax liability after the commencement of the bankruptcy case.²⁷⁴ Although the debtor will succeed to the estate's unused tax attributes upon the termination of the bankruptcy estate,²⁷⁵ she loses any benefit from those tax attributes during the pendency of the proceeding, thereby impeding her fresh start after bankruptcy.²⁷⁶

Moreover, because all of the enumerated tax attributes transfer to the estate as of the commencement of the debtor's bankruptcy proceeding, the debtor will not have any tax attributes available to be reduced by the amount of her discharge of indebtedness income discussed above. Recall that discharge indebtedness income disappears with no tax consequences to the debtor if the debtor has no tax attributes available for reduction.²⁷⁷ Such a result would run contrary to traditional notions of tax and bankruptcy policy because the government would

272. See Treas. Reg. §§ 1.1398-1(c), 1.1398-2(c) (1994). Unused passive activity losses and credits are defined in I.R.C. § 469(d)(1)-(2), and unused at-risk losses, referred to in the regulations as unused section 465 losses, are governed by I.R.C. § 465. The Treasury Department has also issued proposed regulations providing that the debtor's election to exclude from income gain from the sale of a principal residence is a tax attribute that transfers to the bankruptcy estate upon commencement of the case. Treas. Reg. § 1.1398-3 (2002) ("The bankruptcy estate succeeds to and takes into account the section 121 exclusion with respect to the property transferred into the estate."); see also I.R.C. § 121 (2000).

273. I.R.C. § 1398(g).

274. See, e.g., MCQUEEN & WILLIAMS, *supra* note 30, § 24:4, at 24-6.

275. I.R.C. § 1398(i) (2000). The attributes to which the debtor succeeds as of the termination of the estate are identical to those to which the estate succeeds at the beginning of the bankruptcy proceeding, with one notable exception. The debtor does not succeed to the method of accounting used by the bankruptcy estate. See I.R.C. § 1398(i); see also NEWTON & BLOOM, *supra* note 270, § 4.16, at 142. Moreover, regulations provide that the debtor succeeds to the estate's unused passive activity loss and credit carryovers, as well as its unused at-risk losses. See Treas. Reg. §§ 1.1398-1(e), 1.1398-2(e) (1994).

276. See, e.g., Williams, *supra* note 28, at 183-84.

277. See *supra* note 257.

lose the revenue generated by the pre-tax appreciation in the debtor's assets simply because the debtor filed for bankruptcy protection.

Accordingly, under this Article's proposal, the law should be amended so that the debtor retains the tax attributes arising before the filing of her bankruptcy petition that would otherwise pass to the estate under section 1398(g) of the Tax Code.²⁷⁸ Thus, when the debtor recognizes discharge of indebtedness income upon the sale or other disposition of an asset during bankruptcy, her tax attributes will be reduced by the amount of such income. This proposal can be justified from a tax policy perspective because it merely defers the recognition of this discharge of indebtedness income rather than excluding the income from tax forever.

D. POTENTIAL CRITICISMS OF THE PROPOSAL

Like any other proposed change in the law, this new paradigm for the tax treatment of abandonments in bankruptcy could be subjected to criticism. The two major criticisms that might be waged against this proposal are that it addresses only pre-appreciation gain and that it disfavors the debtor by offsetting tax attributes that could otherwise reduce ordinary income by an amount that would generally be treated as capital gain. This section of the Article addresses these potential criticisms.

With respect to the pre-appreciation gain issue, recall that, upon the creation of a bankruptcy estate, all of the debtor's assets owned as of the commencement of the bankruptcy case transfer to that estate by operation of law.²⁷⁹ The bankruptcy judge then values each of these assets for purposes of the bankruptcy proceeding. Accordingly, upon the sale or other disposition of an estate asset during the proceeding, the resulting gain can easily be divided into pre-petition appreciation and post-petition appreciation, based on the valuation assigned to such asset at the commencement of the case. As suggested previously, the pre-bankruptcy appreciation is taxed to the debtor as discharge of in-

278. Professor Williams's proposal suggested that only those tax attributes attributable to properties creating the pre-appreciation gain be retained by the debtor to offset against discharge of indebtedness income. See *supra* note 220 and accompanying text. Although Professor Williams recognized the unfairness of charging the debtor with discharge of indebtedness income without giving the debtor tax attributes to be reduced by that income, his proposal did not go far enough in resolving the issue.

279. See 11 U.S.C. § 541 (2000); see also *supra* notes 54–56 and accompanying text.

debtedness income. With respect to post-petition appreciation of an asset, this Article proposes that that appreciation be taxed to the debtor as discharge of indebtedness income if the debtor retains the asset as exempt property or the asset reverts back to the debtor upon its abandonment by the trustee. Alternatively, the Article suggests that the post-petition gain should be taxed to the estate if the estate sells the asset for the benefit of unsecured creditors. This bifurcated scheme simply comports with the fundamental notion of tax policy that the taxpayer who enjoys the benefits of an asset's appreciation in value bear the burden of the tax attributable to that appreciation.²⁸⁰

With respect to the proposal's second potential criticism, it is important to recognize at the outset that the gain arising from the sale or other disposition of a debtor's assets in bankruptcy would, in most circumstances, constitute capital gain.²⁸¹ Because this gain will be treated as discharge of indebtedness income under this Article's proposal, the gain will reduce the debtor's net operating losses and other tax attributes that could otherwise offset ordinary income. Critics might argue that such tax treatment is unfair to the debtor because it forces the debtor to reduce these valuable tax attributes by capital gain that would ordinarily be taxed at preferential rates.²⁸²

The response to this criticism is twofold. First, this problem already exists with respect to discharge of indebtedness income under current law because such income reduces a debtor's basis in his assets (among other tax attributes), thereby converting what would otherwise be ordinary income into capital gain as a

280. See *supra* note 163 and accompanying text.

281. Gain on the sale or other disposition of an asset will constitute capital gain if two requirements are met. First, the asset must be a capital asset in the hands of the taxpayer. See I.R.C. § 1222(1)–(4) (2000). For a definition of what items of property constitute capital assets, see *id.* § 1221. Second, there must be a sale or exchange of that capital asset. See *id.* § 1222(1)–(4). There is, however, an exception to the general rule that the sale or exchange of a capital asset will give rise to capital gain. Under the rules of recapture, gain on the sale of personal property will be treated as ordinary income, rather than capital gain, in an amount equal to the depreciation deductions previously taken with respect to the property. See *id.* § 1245(a). Similarly, gain on the sale of real property will be treated as ordinary income in an amount equal to the excess of accelerated depreciation deductions taken with respect to the property over straight-line depreciation. See *id.* § 1250(a). Because most real property must now be depreciated using the straight-line method, however, see *id.* § 168(b)(3), there is little recapture income created on the sale of real property under the current Tax Code.

282. Of course, only long-term capital gain is taxed at preferential rates. See *id.* §§ 1(h), 1222(11).

result of this reduction of basis. Although critics can argue that this conversion of ordinary income into capital gain is beneficial to the debtor, this example illustrates the mismatching that already exists. Moreover, offsetting capital gain against tax attributes that would otherwise reduce ordinary income is simply necessary to unify bankruptcy and tax policy without adding undue complexity to the tax system.

CONCLUSION

The three-pronged proposal outlined in this Article provides a comprehensive solution to the vexing problem of the tax treatment of abandonments in bankruptcy by harmonizing competing tax and bankruptcy policies. Tax policy is furthered because tax is imposed on the taxpayer who enjoyed the benefits of the appreciation inherent in the property, irrespective of whether that property is retained by the debtor for her fresh start, abandoned by the trustee as burdensome to the bankruptcy estate, or sold by the trustee for the benefit of creditors. Similarly, the proposal advances sound bankruptcy policy by postponing the debtor's tax burden until a time when she has funds available to meet that tax burden, thereby preserving her fresh start after bankruptcy to the greatest extent possible. At the same time, the proposal furthers the bankruptcy policy of providing a fair and equitable distribution to unsecured creditors by not burdening the bankruptcy estate with taxes from the sale or disposition of an asset that does not inure to the creditors' benefit economically. Congressional adoption of this comprehensive paradigm will bring the bankruptcy system one step closer to operating efficiently and effectively during these difficult economic times.