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I. INTRODUCTION

On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"),[1] the most sweeping bankruptcy reform legislation passed by Congress in over a quarter of a century.[2] The bill, which spanned over 600 pages,[3] completely

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1. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.).

2. *See, e.g.*, Susan Jensen, *A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 485, 485 (2005) ("Although its genesis can be traced to the formation of a commission charged by Congress with a modest mandate to review the state of the bankruptcy law and system, the end product represents one of the most comprehensive overhauls of the Bankruptcy Code in more than twenty-five years."); Bruce C. Scalambrino, *The Bankruptcy Reform for Non-Bankruptcy Lawyers*, 93 ILL. B.J. 518, 518 (2005) ("The new law makes the most sweeping changes to bankruptcy law since the 1978 enactment of the Bankruptcy Code . . . ."); Despite this fact, Congress considered the bill for less than two months before passing it overwhelmingly. Mario A. Mata, *Asset Protection Techniques for Real Estate Owners*, SL033 ALI-ABA 605, 611 (2005)

> (After eight years of fierce debate and near misses, Congress finally passes the most sweeping overall [overhaul] of bankruptcy law when, on April 15, 2005, by a vote of 302-126, the U.S. House of Representatives passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The House vote came approximately one month after the Senate voted 74-25 to pass the Bill. All proposed amendments to the proposed legislation were summarily defeated in the House of Representatives as part of a concerted effort to pass the legislation without any amendments to the version passed by the Senate one month earlier.);

see also 151 CONG. REC. S1725-07 (Feb. 28, 2005) (statement of Sen. Frist).

3. *See* Ann D. Zeigler & Steven D. Shum, *Major Changes Made to Business Bankruptcy Practice: Critical Information the Occasional Practitioner Needs to Know Now about the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, HOUS. LAW., Sept./Oct. 2005, at 38, 42.

overhauled the consumer bankruptcy system and made significant changes to business bankruptcies as well.[4] Yet despite Congress's massive effort to improve the current bankruptcy system in BAPCPA, it failed to address a number of important issues in the area of bankruptcy taxation, a critical but often overlooked area of bankruptcy law.[5] One such issue involves the tax consequences of property abandonments in a bankruptcy proceeding.

The abandonment issue is best understood through an example. Assume that a debtor owns three apartment complexes with a total value of $53 million. The apartments' combined adjusted basis is $13 million; thus, there is a $40 million taxable gain inherent in the buildings. The apartments are encumbered by liens of nearly $60 million.[6] The debtor files a Chapter 11 bankruptcy petition and the bankruptcy trustee seeks to abandon the apartment complexes as burdensome to the bankruptcy estate, because their liabilities exceed their fair market value, leaving no value for the estate's unsecured creditors.[7] In this example, the tax issue that arises is whether the trustee's abandonment of the properties is a taxable or nontaxable transfer. If it is taxable, then by abandoning the apartment complexes, the bankruptcy trustee triggers taxation of the complexes' built-in gain of $40 million to the bankruptcy estate. If, on the other hand, the abandonment is not a taxable transfer, then the $40 million gain inherent in the apartments will be taxable to the debtor when he later transfers the property in a taxable transaction, most likely to the secured creditor upon foreclosure.[8]

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4. *See, e.g.*, Roger Cox, *BAPCPA 2005: Changes Affecting Business Bankruptcies*, 68 TEX. B.J. 1012, 1012-16 (2005); Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603 (2005); Henry J. Sommer, *Trying to Make Sense Out of Nonsense: Representing Consumers Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 191 (2005); Joel B. Weinberg, *DEBTOR BEWARE the New Bankruptcy Law Eliminates the Bankruptcy Code's Prior Presumption in Favor of Granting the Relief Sought by the Debtor*, LOS ANGELES LAW., Oct. 2005, at 22.

5. Only 20 of the 206 provisions of BAPCPA dealt with bankruptcy tax issues. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23, 124-34 (2005) (codified as amended in scattered sections of 11 U.S.C.). In fact, the last time that Congress systematically considered bankruptcy taxation issues was in 1980, when it passed the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389 (codified as amended in scattered sections of 26 U.S.C.); *see also* 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.").

6. These are the slightly simplified facts of one of the leading cases in the abandonments area, *In re* A.J. Lane & Co., 133 B.R. 264, 266-67 (Bankr. D. Mass. 1991).

7. For a more comprehensive discussion of the requirements for abandonment, see *infra* notes 29-36 and accompanying text.

8. A foreclosure of property is a realization event for tax purposes, triggering the recognition of gain. *See* Helvering v. Hammel, 311 U.S. 504, 510-11 (1941).

Because this issue has ramifications for both tax and bankruptcy law, both the Tax Code[9] and the Bankruptcy Code are relevant in resolving it. Yet, while both statutes contain provisions that bear on the issue, neither statute fully settles it. Similarly, the few courts that have considered the issue have not reached any consensus on how to resolve it.[10]

Unlike issues such as means testing[11] and exemption planning,[12] which have received massive attention in both the media[13] and academic journals,[14] the tax consequences of abandonments have garnered little attention in either venue. Yet despite the fact that academics and the mass media alike have

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9. All references in this Article to the Tax Code are to the Internal Revenue Code of 1986, as amended, unless specifically stated otherwise.

10. See *infra* notes 48-49 and accompanying text for a discussion of the cases bearing on the abandonment issue.

11. For a comprehensive discussion of the concept of means testing, see Eugene R. Wedoff, *Means Testing in the New § 707(B)*, 79 AM. BANKR. L.J. 231 (2005); *see also* 11 U.S.C. § 707(b) (Supp. V 2005).

12. *See, e.g.*, Margaret Howard, *Exemptions Under the 2005 Bankruptcy Amendments: A Tale of Opportunity Lost*, 79 AM. BANKR. L.J. 397 (2005); *see also* 11 U.S.C. § 522(o)-(p) (Supp. V 2005). In fact, exemption planning has already been the subject of a flurry of bankruptcy court cases in 2005. *See In re* McNabb, 326 B.R. 785, 788 (Bankr. D. Ariz. 2005) (The $125,000 homestead exemption limit of 11 U.S.C. § 522(p) applies only in those states that have not opted out of the federal exemption scheme.); *but see In re* Virissimo, 332 B.R. 201, 205-06 (Bankr. D. Nev. 2005) (BAPCPA's legislative history confirms that Congress intended the $125,000 cap of § 522(p) to apply equally to opt-out and non-opt-out states.); *In re* Kaplan, 331 B.R. 483, 486 (Bankr. S.D. Fla. 2005) (The § 522(p) cap applies to all states, including those that have opted out of the federal exemption provisions.).

13. *See, e.g.*, Amy Borrus & Anne Tergesen, *Not Necessarily A Fresh Start on October 1, Bankruptcy Will Get Tougher and Costlier. Here's What You Need To Know*, BUS. WK., July 11, 2005, at 84; Reni Gertner, *What Does the New Bankruptcy Law Have to Offer?*, KAN. CITY DAILY REC., Sept. 19, 2005, at 1-2; Richard Mullins, *Bankruptcy Filers Line Up As Deadline Looms*, TAMPA TRIB., Oct. 15, 2005, Nation/World section, at 1, *available at* 2005 WLNR 17134169; Terry Savage, *Many New Changes in Bankruptcy Laws*, CHI. SUN-TIMES, Apr. 25, 2005, at 65; Lawrence A. Young, et al., STANDARD & POOR'S THE REV. OF BANKING & FIN. SERV., July 1, 2005, *available at* 2005 WLNR 12702701.

14. *See, e.g.*, David W. Allard, *Means Testing, Dismissal and Conversion Under the New Law*, 24 AM. BANKR. INST. J. 8 (Aug. 2005); G. Eric Brunstad Jr., *The Inapplicability of "Means Testing" to Cases Converted to Chapter 7*, 24 AM. BANKR. INST. J. 1 (Nov. 2005); Richard M. Hynes, Anup Malani & Eric A. Posner, *The Political Economy of Property Exemption Laws*, 47 J.L. & ECON. 19 (2004); David A. Samole & David L. Rosendorf, *Homestead Exemptions No Longer "Debtors' Paradise,"* 24 AM. BANKR. INST. J. 6 (Jan. 2006); *see also* Ted Janger, *Crystals and Mud in Bankruptcy Law: Judicial Competence and Statutory Design*, 43 ARIZ. L. REV. 559, 615-20 (2001).

virtually ignored the issue,[15] it is of enormous importance in the bankruptcy arena. The issue of how property abandonments are treated for tax purposes goes to the very core of the bankruptcy system by placing into direct conflict the dual policy justifications upon which the system is built: providing a fresh start to deserving debtors[16] while furnishing a fair and equitable distribution to creditors.[17]

In 1996, the Commercial Law League of America embarked on an empirical study to determine whether property abandonments in bankruptcy proceedings had a measurable effect on the value of assets distributed to creditors in Chapter 7 proceedings.[18] The results were astonishing. The study estimated that over $340,000,000 in assets were being abandoned by bankruptcy trustees rather than being sold for the benefit of unsecured creditors because the tax liability arising from the sales of those assets would have been overly burdensome to debtors' bankruptcy estates.[19] The Commercial Law League study concluded that 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."[20] Similarly, a study of bankruptcy proceedings in Richmond, Virginia, over a four-year period demonstrated that in over ninety-seven percent of the cases studied that involved secured creditors, the bankruptcy trustee abandoned at least some assets to either the debtor or a secured creditor.[21]

In an article published in the *Minnesota Law Review* in 2004, I proposed a three-pronged solution to the bankruptcy abandonments issue.[22] In that article, I argued that because the debtor benefited from the appreciation inherent

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15. For the most comprehensive discussion of the abandonments issue by an academic, see Jack F. Williams, *The Tax Consequences of Abandonment Under the Bankruptcy Code*, 67 TEMP. L. REV. 13 (1994); *see also* Kenneth C. Weil, *Effects of Real Property Abandonments in Bankruptcy*, 70 J. TAX'N 358 (1989).

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

17. *See* Burlingham v. Crouse, 228 U.S. 459, 473 (1913).

18. *Impact of Potential Capital Gain Taxes on the Sale of Assets in Bankruptcy Cases*, COM. L. BULL., May/June 1996, at 21 [hereinafter *Impact*]; *see also* Max G. Moses, *Proposal for Capital Gain Taxes and Bankruptcy Cases*, 102 COM. L.J. 219, 219-20 (1997). This study is discussed more fully in Michelle Arnopol Cecil, *Abandonments in Bankruptcy: Unifying Competing Tax and Bankruptcy Policies*, 88 MINN. L. REV. 723, 727-28, 754-58 (2004).

19. Moses, *supra* note 18, at 220; *Impact, supra* note 18, at 21.

20. *Impact, supra* note 18, at 21.

21. 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).

22. *See* Cecil, *supra* note 18, at 765-80.

in the property before filing for bankruptcy, it should be the debtor who is required to pay the tax on the gain that is built into the asset when the bankruptcy proceeding is initiated.[23] In addition, I proposed that, because a debtor in bankruptcy may not have sufficient funds to pay the tax on the built-in gain inherent in the asset upon filing, recognition of the gain should be postponed until a later time.[24] By treating the gain as discharge of indebtedness income,[25] the debtor will be able to postpone including the gain in income until she has the ability to pay the resulting tax, usually upon a later disposition of the property.[26] In the third prong of my proposal, I argued that the debtor should be entitled to retain her tax attributes, which include her net operating losses, capital loss carryovers, and tax credit carryovers, so that these tax attributes could be used to offset the debtor's discharge of indebtedness income that arises from the abandoned property.[27]

After *Abandonments in Bankruptcy* was published in 2004, several academics and other tax experts asked how my proposal would deal with gain accruing in an asset after the debtor files his bankruptcy petition.[28] Should post-petition appreciation be taxed to the debtor or to the bankruptcy estate? Moreover, if it is the debtor who bears the burden of the tax on post-petition gain, should all post-petition gain be treated as discharge of indebtedness income, or only the gain that accrues until the termination of the bankruptcy proceeding? It is these follow-up issues that this Article seeks to address. Part II of this Article explores both the bankruptcy and tax provisions that bear on the tax treatment of property abandonments in a bankruptcy proceeding. Part III outlines in greater detail the three-pronged proposal, set forth in *Aban-*

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23. *Id.* at 766-67; *see also infra* Part III.A. This article will be referred to hereinafter as *Abandonments in Bankruptcy*.

24. Cecil, *supra* note 18 at 767-77.; *see also infra* Part III.B.

25. For a comprehensive review of the concept of discharge of indebtedness income, see *infra* notes 61-74 and accompanying text. The notion that the built-in gain inherent in an asset abandoned by the trustee be treated as discharge of indebtedness income was first proposed by the National Bankruptcy Conference in 1994. *See* NAT'L BANKR. CONFERENCE, REFORMING THE BANKRUPTCY CODE: THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT 89-91 (1994). The Report, however, failed to consider fundamental issues such as whether the bankruptcy estate or the debtor should bear the burden of the debt discharge income. For a more complete discussion of the Conference's Report, see Cecil, *supra* note 18, at 761-62.

26. Most often, the debtor pays the tax upon a disposition of the property, either by selling the property to a third party or through foreclosure of the property by the secured creditor. However, the debtor may pay tax on the gain at an earlier time if, under the discharge of indebtedness rules, the debtor is required to reduce her net operating losses by the amount of debt discharge income, thereby making those net operating losses unavailable to reduce other income in the future. For a more comprehensive discussion of the discharge of indebtedness rules, see *infra* notes 61-74 and accompanying text; *see also* Cecil, *supra* note 18, at 770-75.

27. *See* Cecil, *supra* note 18, at 777-80; *see also infra* Part III.C.

28. *See infra* note 86 and accompanying text.

donments in Bankruptcy, resolving the bankruptcy abandonments issue. Finally, Part IV grapples with how post-petition gain should be treated for tax purposes when that property becomes part of a debtor's bankruptcy estate.

II. STATUTORY PROVISIONS BEARING ON THE ABANDONMENT ISSUE

Section 554 of the Bankruptcy Code allows a bankruptcy trustee to abandon property that is burdensome to the bankruptcy estate or is otherwise of inconsequential value to the estate.[29] The Bankruptcy Code allows a trustee to use these abandonment powers in order to maximize the value of the estate, and, hence, the payout to unsecured creditors.[30] Legislative history suggests

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29. 11 U.S.C. § 554(a) (2000); *see also* S. REP. NO. 95-989, at 92 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5878.

30. 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 one recent bankruptcy case, the court was faced with the issue of how the trustee's abandonment power was affected by section 724 of the Bankruptcy Code, which provides for the subordination of tax liens under certain circumstances. Grochocinski v. Laredo (*In re* Laredo), 334 B.R. 401 (Bankr. N.D. Ill. 2005). In *Laredo*, the debtors, a husband and wife, filed a Chapter 7 bankruptcy petition. *Id.* at 404. Their home, which became property of the estate, was encumbered by two consensual mortgage liens of $224,971.21 and $25,000, as well as a secured I.R.S. tax lien of $114,842.07. *Id.* The trustee sought a determination of the priority of these liens if the home was sold. *Id.* at 405.
Section 724 of the Bankruptcy Code provides for the subordination of tax liens to other claims under certain circumstances. It provides:

> (b) Property in which the estate has an interest and that is subject to a lien that is not avoidable under this title . . . and that secures an allowed claim for a tax, or proceeds of such property, shall be distributed--
> (1) first, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is senior to such tax lien;
> (2) second, to any holder of a claim of a kind specified in section 507(a)(1), . . . 507(a)(2), 507(a)(3), 507(a)(4), 507(a)(5), 507(a)(6), or 507(a)(7) of this title, to the extent of the amount of such allowed tax claim that is secured by such tax lien;
> (3) third, to the holder of such tax lien, to any extent that such holder's allowed tax claim that is secured by such tax lien exceeds any amount distributed under paragraph (2) of this subsection;
> (4) fourth, to any holder of an allowed claim secured by a lien on such property that is not avoidable under this title and that is junior to such tax lien;
> (5) fifth, to the holder of such tax lien, to the extent that such holder's allowed claim secured by such tax lien is not paid under paragraph (3) of this subsection; and
> (6) sixth, to the estate.

11 U.S.C. § 724(b) (Supp. V 2005). In *Laredo*, the court first noted that the primary policy justification for section 724 is to subordinate tax liens in order to further the debtor's fresh start by favoring priority unsecured claimants, such as wage earners

that the trustee can abandon property to any party with a possessory interest in it.[31] Those parties with a possessory interest in the abandoned property would include the debtor and, in some cases, a secured creditor.[32] If property is abandoned by the trustee to the debtor, the abandonment is treated as relating back to the time that the case is commenced; as a result, title revests in the debtor and, for bankruptcy purposes, it is treated as if the estate never owned the property.[33] Once the trustee abandons property, however, the abandonment is irrevocable, even if the abandonment decision was based on an erroneous undervaluation of the property.[34]

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and estate administration costs, over tax liens. 334 B.R. at 411-12. "The only parties affected by the operation of § 724(b) are the priority claimants and the tax lien creditors. The rights and claims of both senior and junior lienors and the holders of non-priority unsecured claims are left undisturbed." *Id.* at 412 (quoting *In re* Bino's Inc., 182 B.R. 784, 787 (Bankr. N.D. Ill. 1995)) (citation omitted). Accordingly, section 724 of the Bankruptcy Code has little, if any, effect on the abandonment issue because the trustee is generally seeking abandonment in order to enhance the value of the bankruptcy estate for general unsecured creditors, who are unaffected by the special distribution scheme established in section 724. *Id.* at 415.

31. *See* S. REP. NO. 95-989, at 92, *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5878; H.R. REP. NO. 95-595, at 377 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6333.

32. *See* 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* Popp, 166 B.R. 697, 700 (Bankr. D. Neb. 1993) (mem.).

33. *In re* Nevin, 135 B.R. 652, 653 (Bankr. D. Haw. 1991) (mem.) (citing Mason v. Comm'r, 68 T.C. 163 (1977), *aff'd*, 646 F.2d 1309 (9th Cir. 1980) (per curiam)). It is important to note that the court retains jurisdiction over property that is abandoned. Thus, the court retains the power to decide issues relating to violations of the automatic stay and issues regarding the dischargeability of debts relating to the abandoned property. *See, e.g.*, Dunmore v. United States (*In re* Dunmore), 254 B.R. 761, 763 (Bankr. N.D. Cal. 2000) (mem.).

34. *See In re* Tadlock, 338 B.R. 436, 439 (B.A.P. 10th Cir. 2006); *In re* Brio Ref., Inc., 86 B.R. 487, 490 (N.D. Tex. 1988) (mem.); *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. 2005). There are, however, some courts that have distinguished between a formal abandonment, when the trustee invokes her abandonment power pursuant to section 554 of the Bankruptcy Code to abandon property back to the debtor, and technical abandonment, in which the bankruptcy estate closes prematurely and property remaining in the estate is abandoned to the debtor by operation of law. *See, e.g.*, *In re* Balonze, 336 B.R. 160 (Bankr. D. Conn. 2006); Neville v. Harris, 192 B.R. 825 (D.N.J. 1996). In the technical abandonment scenario, several courts have modified or revoked the abandonment once the case was reopened under section 350(b). *See, e.g.*, *Balonze*, 336 B.R. at 170; *Neville*, 192 B.R. at 832. The trustee's right to abandon property is not absolute. For a comprehensive discussion of judicial limitations imposed on the trustee's abandonment power, see Cecil, *supra* note 18, at 732.

Most often, a trustee will abandon property as burdensome to the bankruptcy estate when the property is encumbered by a liability that exceeds its fair market value.[35] Consider the following example. A debtor files for bankruptcy owning a printing press used in his trade or business with a fair market value of $25,000, and subject to a valid, unavoidable lien of $30,000. In this case, the trustee should abandon the printing press back to the debtor because the lien exceeds the fair market value of the property, leaving no value in the bankruptcy estate to benefit unsecured creditors. In addition, because the debtor is entitled to take exemptions before any value in the bankruptcy estate goes to unsecured creditors, even if the lien were only $20,000, if the debtor is entitled to a $5,000 tool of the trade exemption under his state's exemption statute, the trustee should still abandon the property as of inconsequential value to the debtor's bankruptcy estate because the $20,000 lien, coupled with the debtor's $5,000 exemption, consume the full $25,000 value of the printing press, leaving no value to go into the bankruptcy estate for the benefit of 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.[36] For example, assume that a debtor purchases Blackacre for $10,000 in 1975. In 2004, 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 $70,000. 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 2005, with Blackacre becoming property of the estate by operation of law. 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 $10,000 of remaining equity would be insufficient to pay income taxes on the $60,000 gain inherent in the property.

Courts that have considered this issue have reached conflicting results, largely because the provisions of the Tax Code governing the tax consequences of abandonments do not squarely address the issue.[37] Thus, it is necessary to examine the relevant provisions of the Tax Code.

Under the Tax Code, gain inherent in property is not recognized, or included in a taxpayer's gross income, until there is a realization event, which is loosely defined as a sale or other disposition of the property.[38] The amount

35. *See, e.g.*, *In re* Burpo, 148 B.R. 918, 919 (Bankr. W.D. Mo. 1993) (mem.).

36. For a comprehensive discussion of the conflicting case law on this issue, see Cecil, *supra* note 18, at 737-48.

37. *See, e.g.*, *In re* A. J. Lane & Co., 133 B.R. 264, 267-74 (Bankr. D. Mass. 1991); *but see* Samore v. Olson (*In re* Olson), 930 F.2d 6, 8 (8th Cir. 1991); *see also* *infra* notes 48-49 and accompanying text.

38. *See* I.R.C. § 1001(a), (c) (2000).

of gain that a taxpayer must include in gross income at that time is equal to the difference between her amount realized on the sale or disposition and her adjusted basis in the property.[39] Case law has established that realization events include the transfer of property to pay off a liability,[40] an abandonment of property,[41] and a secured creditor's foreclosure of property.[42] These general income tax rules apply equally if a trustee sells or otherwise disposes of a debtor's property while it is part of the bankruptcy estate, either through a sale of the property[43] or through foreclosure by a secured creditor.[44] The issue that remains unresolved, however, is whether an abandonment by the trustee during the pendency of a bankruptcy proceeding is considered a realization event for tax purposes.

The Tax Code deals only briefly with the tax consequences of transfers into and out of the bankruptcy estate.[45] 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."[46] 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 upon filing a bankruptcy petition.

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."[47] 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. Thus, the estate will not be taxed on any gain or loss inherent in estate property at the time of the

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39. *Id.* § 1001(a). Case law has held that amount realized includes both recourse liabilities assumed by the purchaser, as well as nonrecourse liabilities attached to the property. *See, e.g.*, Comm'r v. Tufts, 461 U.S. 300, 312-13 (1983); Crane v. Comm'r, 331 U.S. 1, 14 (1947).

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

41. *See* Yarbro v. Comm'r, 737 F.2d 479, 486 (5th Cir. 1984); Middleton v. Comm'r, 77 T.C. 310, 320-21 (1981), *aff'd*, 693 F.2d 124 (11th Cir 1982) (per curiam).

42. *See* Helvering v. Hammel, 311 U.S. 504, 510-12 (1941).

43. *See* Waldschmidt v. Comm'r (*In re* Lambdin), 33 B.R. 11, 12-13 (Bankr. M.D. Tenn. 1983) (mem); *see also* S. REP. NO. 95-989, at 66 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5852.

44. *See* Williams, *supra* note 15, at 40-41.

45. The following two paragraphs are taken in substantial part from Cecil, *supra* note 18, at 736-37.

46. I.R.C. § 1398(f)(1) (2000).

47. *Id.* § 1398(f)(2).

reversion.[48] 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, and case law on the issue reaches conflicting results.[49]

III. RESOLVING THE BANKRUPTCY ABANDONMENT ISSUE

In *Abandonments in Bankruptcy*, I argued in favor of adopting a three-pronged approach to the bankruptcy abandonment issue.[50] Because the unresolved issues addressed in Part IV of this article expand upon this approach, this section outlines the three-pronged solution briefly to provide necessary background.

A. Treating Abandonments As Non-Taxable Events

First, I contended that the debtor, and not the bankruptcy estate, should be responsible for paying the tax on any pre-petition appreciation in an asset, because the non-tax benefits arising out of that appreciation accrued to the debtor before bankruptcy.[51] For example, the debtor was able to use and enjoy the asset before filing, and he also had the ability to use the appreciation in that asset as collateral for a loan, the proceeds from which could be used for pleasure, investment, or to improve the debtor's business.[52] Traditional notions of tax policy dictate that the party who enjoys a property's appreciation in value should pay the tax on that appreciation.[53] Thus, I argued that the debtor should pay the tax resulting from pre-petition gain inherent in an asset, irrespective of whether that asset is sold by the trustee, retained by the debtor

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

49. *See, e.g., In re* A.J. Lane & Co., 133 B.R. 264, 269-75 (Bankr. D. Mass. 1991) (holding that a trustee's abandonment was a taxable transfer, resulting in gain to the bankruptcy estate); *see also In re* Rubin, 154 B.R. 897, 899 (Bankr. D. Md. 1992) (mem.); *but see* Samore v. Olson (*In re* Olson), 930 F.2d 6, 8 (8th Cir. 1991) (per curiam) (holding that an abandonment by the trustee during the pendency of a bankruptcy proceeding is a non-taxable transfer; thus, the bankruptcy estate is not required to recognize as income the property's built-in gain); 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). For a more in depth discussion of the case law addressing the tax consequences of abandonments in bankruptcy, see Cecil, *supra* note 18, at 737-48.

50. *See* Cecil, *supra* note 18, at 765-82.

51. *Id.* at 766.

52. *See* 1 NAT'L BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS – NATIONAL BANKRUPTCY REVIEW COMMISSION FINAL REPORT 971 (1997).

53. *Id.*

for his fresh start, or abandoned by the trustee because it is burdensome to the bankruptcy estate.[54]

As discussed previously,[55] 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.[56] In *Abandonments in Bankruptcy*, I took a position contrary to this weight of authority, arguing 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. I argued that 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.[57] 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.[58] 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. From a policy perspective, I argued that the debtor should bear the tax burden in both situations because the debtor enjoyed the benefit of the property's appreciation in both instances.[59]

Accordingly, I proposed that both the Tax Code and the Bankruptcy Code be amended to clarify that the trustee's abandonment of property back to the debtor or to a secured creditor with a possessory interest in the property should not constitute a realization event for tax purposes.[60] In addition, as outlined in greater detail below, the debtor's tax liability with respect to the gain inherent in the abandoned property should not arise until the debtor later sells or disposes of the property, triggering the realization of gain.[61]

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54. *See* Cecil, *supra* note 18, at 766.

55. *See supra* notes 39-45 and accompanying text.

56. *See* S. REP. NO. 95-989, at 66 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5852; *see also In re* Swann, 149 B.R. 137, 146 (Bankr. D.S.D. 1993) (mem.); Waldschmidt v. Comm'r (*In re* Lambdin), 33 B.R. 11, 12-13 (Bankr. M.D. Tenn. 1983) (mem.). It should be noted that this paragraph is taken in substantial part from Cecil, *supra* note 18, at 768.

57. *See, e.g.*, Samore v. Olson (*In re* Olson), 930 F.2d 6, 8 (8th Cir. 1991) (per curiam).

58. *See supra* notes 39-45 and accompanying text.

59. *Id.*

60. *See* Cecil, *supra* note 18, at 766.

61. *See* I.R.C. § 1001(a) (2000).

B. Treating The Debtor's Gain as Discharge of Indebtedness Income

Although the gain resulting from the sale or disposition of an asset of the bankruptcy estate should be taxed to the debtor (whether the asset is sold by the trustee for the benefit of creditors or abandoned by the trustee and later sold by the debtor or foreclosed upon by a secured creditor), usually the debtor will not have the cash available to pay the resulting tax because she is in financial distress. To remedy this problem, in *Abandonments in Bankruptcy* the *Minnesota* article, I proposed that the gain should be treated as discharge of indebtedness income.[62] Following is a brief explanation of the concept of discharge of indebtedness income.

Section 61 of the Tax Code requires a taxpayer to include in gross income "income from whatever source derived."[63] The Supreme Court has stated that gross income includes any accession to the taxpayer's wealth.[64] 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.[65] 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.[66] 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.*[67] The policy justification for including discharge of indebtedness in gross income, 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.[68] Although *Kirby Lumber*'s theoretical

62. *See* Cecil, *supra* note 18, at 767-77. In this article I noted that the notion that this income be treated as discharge of indebtedness income was first proposed by the National Bankruptcy Conference in 1994. *See* NAT'L BANKR. CONFERENCE, *supra* note 25, at 89-91. The Conference failed, however, to decide whether the debtor or the bankruptcy estate should be responsible for this discharge of indebtedness income.

63. I.R.C. § 61(a) (2000). Much of the next three paragraphs was taken from Cecil, *supra* note 18, at 770-75, although the footnotes have been shortened considerably.

64. *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

65. *See* United States v. Rochelle, 384 F.2d 748, 751 (5th Cir. 1967), *cert. denied*, 390 U.S. 946 (1968) ("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.").

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

67. *Id.*; *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 2)).

68. *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*

underpinnings have been challenged by tax scholars,[69] this net worth approach is consistent with traditional notions of a comprehensive income tax base,[70] and the concept of including discharges of indebtedness in gross income is now clearly embedded in the income tax system.[71]

The Tax Code offers an exception to the harsh tax consequences of this rule under certain limited circumstances. Section 108(a) of the Tax Code provides that gross income of a taxpayer does not include as income any amount that otherwise would be discharge of indebtedness income if the debt discharge occurs either (i) in a Title 11 bankruptcy proceeding,[72] or (ii) while the taxpayer is insolvent.[73] 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 bank-

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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).

69. *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), in which the authors argued 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 Sav. Bank FSB, 499 U.S. 573, 582 (1991)).

70. For a more detailed discussion of the concept of a comprehensive income tax base, see Cecil, *supra* note 18, at 750-51.

71. *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.") (footnote omitted).

72. I.R.C. § 108(a)(1)(A) (2000). 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." *Id.* § 108(d)(2).

73. *Id.* § 108(a)(1)(B). It should be noted that if this gross income exclusion applies by reason of the taxpayer's insolvency, section 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 section 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.*

ruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability."[74]

There is, however, a toll exacted from taxpayers in bankruptcy and insolvent taxpayers, codified in section 108(b) of the Tax 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 ("NOLs"), general business credits, minimum tax credits, capital loss carryovers, the basis of the taxpayer's property, passive activity loss and credit carryovers, and foreign tax credit carryovers.[75] The Senate Finance Committee explained that the policy underlying these attribute reduction rules was to allow financially distressed debtors to defer the income realized from discharge of indebtedness from their gross income, 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 reasonable period, tax on ordinary income realized from debt discharge."[76]

Applying these discharge of indebtedness rules in the abandonment context is best understood through an example. Returning to my earlier example from the *A.J. Lane* case,[77] assume that a debtor files for bankruptcy protection owning three apartment complexes with a combined fair market value of $53 million and having an adjusted basis of $13 million. The apartments are encumbered by liabilities of approximately $60 million. The bankruptcy trustee abandons these complexes to the debtor as unduly burdensome to the bankruptcy estate, because the liabilities to which the properties are encumbered

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

75. I.R.C. § 108(b)(2) (2000). If a taxpayer is required to reduce the basis in her property under section 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 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. & COMM. 201, 206-09 (1992). Finally, if the taxpayer has none of the tax attributes enumerated in section 108(b)(2), 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.

76. S. REP. NO. 96-1035, at 10 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, 7035; 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, 107 Stat. 312, 487-88 (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.

77. *See supra* notes 6-8 and accompanying text.

exceed their fair market value. Under my proposal, this abandonment will not be a taxable event to the bankruptcy estate.[78]

The debtor is in default on the loans; therefore, the secured creditor seeks relief from the automatic stay to foreclose on the apartment complexes, and that relief is granted by the bankruptcy court.[79] Upon foreclosure, which is a taxable event, the debtor will realize $40 million of discharge of indebtedness income: the difference between the properties' fair market value of $53 million and their adjusted basis of $13 million.[80] Because the debtor is under the jurisdiction of a bankruptcy court in a Title 11 proceeding, however, he will not be required to include that $40 million in gross income. Instead, the debtor will be required to reduce his tax attributes by the $40 million of discharge of indebtedness income.[81] For the sake of simplicity, assume that the debtor had $60 million of net operating losses before filing for bankruptcy. He would be required to reduce his net operating losses from $60 million to $20 million under the Tax Code's discharge of indebtedness rules.[82] If in the future the debtor has gross income of $80 million, he would be able to offset that income by only $20 million of net operating losses, resulting in $60 million of taxable income, rather than $60 million of net operating losses that he had originally accumulated, which would have resulted in only $20 million of taxable income. Accordingly, the government eventually obtains its pound of flesh because the debtor has fewer net operating losses with which to offset his income, resulting in $40 million more taxable income. Not coincidentally, this is the same amount of the debtor's discharge of indebtedness income.

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.[83] 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.[84] Therefore, without a change in the law, the government would not be able to recoup the tax on discharge of indebtedness income in the abandonment situation. The third prong of my proposal remedies this vexing problem.

78. *See supra* notes 51-59 and accompanying text.
79. *See* 11 U.S.C. § 362(d) (Supp. V 2005).
80. I.R.C. § 1001(a) (2000).
81. *See supra* notes 60-74 and accompanying text.
82. *See* I.R.C. § 108(b)(2)(A).
83. This paragraph is taken in large part from Cecil, *supra* note 18, at 777.
84. I.R.C. § 1398(g) (2000).

C. Tax Attribute Retention

As stated above, when a debtor files for bankruptcy, the debtor's bankruptcy estate succeeds to most of her tax attributes by operation of law, including net operating losses, capital loss and tax credit carryovers, charitable contribution carryovers, passive loss and credit carryovers, the debtor's basis and holding period of her assets, and the debtor's method of accounting.[85] As a result of this transfer of tax attributes, the estate can use them to reduce its tax liability on income earned during the pendency of the bankruptcy estate. Any unused tax attributes will transfer back to the debtor at the termination of the estate.[86]

Under my proposal, because the debtor is taxed on any gain inherent in an asset as of the commencement of the bankruptcy proceeding, irrespective of how the property is sold or otherwise disposed of, it should be the debtor, and not the bankruptcy estate, that should have the benefit of these tax attributes. Accordingly, the third prong of my proposal argues that the Tax Code should be amended to allow the debtor to retain the tax attributes that arose before the filing of his bankruptcy petition.[87] These tax attributes can then be reduced by any discharge of indebtedness income recognized by the debtor during the bankruptcy proceeding, thereby postponing, but not eliminating, the debtor's recognition of the gain inherent in the asset at the time of filing.

IV. PROPOSAL FOR ADDRESSING TAX ISSUES ARISING POST-PETITION

Abandonments in Bankruptcy dealt almost exclusively with how to treat the gain inherent in an asset at the time of a debtor's bankruptcy filing for tax purposes. Although I touched on the issue of post-filing appreciation, I did not address the issue in any detail. The remainder of this article will expand on the paradigm set forth in my earlier article and apply it to the issue of how to treat the gain that accrues with respect to an asset after a debtor files for bankruptcy protection.[88]

A. Taxing Post-Petition Appreciation to the Debtor

To better understand this issue, consider the following example. Because of poor investment decisions over a number of years, Suzanne is forced

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85. *Id.*; *see also* Treas. Reg. §§ 1.1398-1(c), 1.1398-2(c) (1994).

86. I.R.C. § 1398(i).

87. *See* Cecil, *supra* note 18, at 779-80.

88. Many of the issues that I address in this section were raised by Gregg Polsky, an Associate Professor at the University of Minnesota Law School, and by John Dethman, Research Librarian and Coordinator of Access Services for the University of Missouri-Columbia School of Law. I thank them for raising these important follow-up issues.

to file for Chapter 7 bankruptcy protection on February 1, 2006. At the time of filing, Suzanne owns Greenacre, an unimproved parcel of land worth $250,000. She purchased the land for $50,000 a number of years ago and has made no improvements to it. Greenacre becomes property of Suzanne's bankruptcy estate by operation of law.[89] Thus, at the time of filing, there is a $200,000 gain built into Greenacre. Shortly after Suzanne files her bankruptcy petition, a national real estate developer announces that a massive shopping center complex will be built on a large tract of land adjacent to Greenacre, and the value of Greenacre immediately increases to $400,000. My earlier proposal provides that Suzanne should be responsible for the $200,000 of pre-petition appreciation inherent in Greenacre, irrespective of whether the trustee abandons the property or sells it for the benefit of creditors and that the $200,000 gain should be treated as discharge of indebtedness income to the debtor.[90] But what about the $150,000 of post-petition appreciation inherent in Greenacre? Should that gain also be taxed to Suzanne as discharge of indebtedness income, or should it instead be taxed to her bankruptcy estate?

In *Abandonments in Bankruptcy* I proposed that the post-petition gain be taxed to the debtor and treated as discharge of indebtedness income if the property was abandoned to the debtor by the trustee or retained by the debtor as exempt property.[91] I also argued that the post-petition gain be taxed to the bankruptcy estate if the trustee sold the asset for the benefit of creditors.[92] However, I have since reconsidered this earlier proposal, and believe that sound tax policy dictates that the debtor should be taxed on the post-appreciation gain inherent in an asset even if the trustee sells the asset for the benefit of unsecured creditors, thus fully extending my original proposal to apply to all post-petition appreciation in an asset. I posit two arguments in support of this change of position.

First, as stated earlier, traditional notions of tax policy dictate that the taxpayer who enjoys the benefits of an asset's appreciation in value should bear the burden of the tax attributable to that appreciation.[93] Clearly, when the

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89. 11 U.S.C. § 541(a) (2000).

90. *See supra* notes 51-82 and accompanying text.

91. *See* Cecil, *supra* note 18, at 780-81.

92. *Id.* at 781. Outside the tax context, cases have held that post-petition appreciation that accrues to an asset when it is part of the bankruptcy estate becomes part of the estate by operation of section 541(a)(6), which provides that "[p]roceeds, product, offspring, rents or profits of or from property of the estate" are property of the estate. 11 U.S.C. § 541(a)(6); *see also In re* Reed, 940 F.2d 1317, 1323 (9th Cir. 1991). Similarly, post-petition appreciation that accrues in property abandoned to the debtor becomes property of the debtor. *See In re* Wornell, 70 B.R. 153, 155 (W.D. Mo. 1986); *In re* Sutton, 10 B.R. 737, 741 (Bankr. E.D. Va. 1981). These cases, however, offer no assistance in determining which party should be taxed on the post-petition appreciation.

93. *See* NAT'L BANKR. REVIEW COMM'N, *supra* note 52, at 970-71.

debtor retains an asset through an exemption for her fresh start, she will enjoy the benefits of all appreciation inherent in the property, whether that appreciation accrues before or after the filing of the debtor's bankruptcy petition. Similarly, when the trustee abandons property back to the debtor as burdensome to the bankruptcy estate, it is the debtor who enjoys the benefits of property's post-petition gain and, accordingly, it should be the debtor who is responsible for the tax on that gain. But does the debtor enjoy the benefits of an asset's post-petition appreciation in value if the trustee sells that property for the benefit of creditors? I argue that the debtor is benefiting more directly from the asset's post-petition appreciation than are the creditors for several reasons. First, if the debtor originally borrowed money to purchase the property, which is almost always the case, the debtor received the borrowed funds on a tax-free basis,[94] and the proceeds from the sale of the property by the trustee will be used, at least in part, to pay off that borrowing. Yet even if an asset is unencumbered by liabilities, the proceeds from the sale of that asset, including the post-petition appreciation inherent in that asset, will be used to pay off the debtor's unsecured creditors. This, too, primarily benefits the debtor, because she received goods or services from her unsecured creditors, again on a tax-free basis, and all of the asset's appreciation is being used to pay those creditors.

There is a second and more pragmatic argument for taxing the debtor on an asset's post-petition gain regardless of whether it is sold by the trustee or abandoned to the debtor. From a tax perspective, the results will be identical whether the gain is taxed to the debtor or to her bankruptcy estate. To understand this phenomenon, return to the Greenacre example from the beginning of the section.[95] If Greenacre is now worth $400,000 and has an adjusted basis of $50,000, there is a $350,000 gain inherent in the property (partly attributable to pre-petition appreciation and partly attributable to post-petition appreciation). If the debtor is taxed on all of the gain, she will have $350,000 of discharge of indebtedness income and will be required to reduce her tax attributes by that amount.[96] Conversely, if the estate is taxed on the $150,000 of post-petition appreciation inherent in Greenacre, it will be required to include that amount in income and will pay taxes on that gain. Assume, for ease of calculation, that the tax rate is twenty percent; therefore, the estate will pay taxes of $30,000 on the post-petition gain when the trustee sells Greenacre. That $30,000 tax liability reduces the assets available for distribution to the estate's unsecured creditors. If the estate has $30,000 less in assets available

94. *See, e.g.*, 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.").

95. *See supra* notes 89-90 and accompanying text.

96. It is important to remember that current law does not treat this gain as discharge of indebtedness income; rather, the proposal that I set forth in my *Minnesota* article establishes this tax treatment. *See* Cecil, *supra* note 18, at 765-80.

for unsecured creditors, then the debtor will have $30,000 more of her debt discharged in the bankruptcy proceeding. This discharged debt will increase the debtor's discharge of indebtedness income by a like amount, with a corresponding reduction in the debtor's tax attributes.[97] Thus, at the conclusion of the bankruptcy proceeding, the debtor will have exactly the same amount of discharge of indebtedness income irrespective of whether the post-petition appreciation in the debtor's assets is taxed to the debtor or to her bankruptcy estate. The only parties affected by taxing the debtor instead of the estate are the debtor's unsecured creditors. For these reasons, I propose that my original paradigm for taxing the debtor on all appreciation inherent in an asset, irrespective of whether that asset is abandoned by the trustee, retained by the debtor for her fresh start, or sold by the trustee for the benefit of creditors, be extended to any appreciation accruing after the debtor files for bankruptcy.

B. Treating Post-Petition Appreciation as Discharge of Indebtedness Income

The previous section established that all post-petition appreciation should be taxed to the debtor; however, the issue that remains is whether all of the resulting gain should be treated as discharge of indebtedness income, as I have proposed should be the case with pre-petition appreciation. As was necessary with the previous section, we must examine the myriad situations in which this issue might arise in order to determine the proper tax consequences to be ascribed to each event.

Consider first the situation in which Greenacre, above, has built-in gain of $350,000 and is unencumbered by liens. The bankruptcy trustee sells Greenacre for the benefit of unsecured creditors. Under my proposal, the debtor is responsible for the full $350,000 gain, even though that gain is attributable to both pre- and post-petition appreciation. In this case, all of the debtor's gain should be treated as discharge of indebtedness income and, because the debtor is under the jurisdiction of a court in a Title 11 bankruptcy proceeding, the debtor should be entitled to defer the recognition of that income by reducing her tax attributes by the $350,000 discharge of indebtedness amount.

In a second scenario, assume that Greenacre is encumbered by a lien in the amount of $400,000, the full fair market value of the property. Clearly the trustee will abandon Greenacre back to the debtor as burdensome to the bankruptcy estate. Under my proposal, the act of abandonment is not a taxable event.[98] Title to Greenacre revests in the debtor, as if the estate had never

97. *See* I.R.C. § 108(b)(1) (2000).

98. *See supra* notes 58-59 and accompanying text.

owned the property.[99] Further assume that the debtor is hopelessly in default on her loan, and the secured creditor seeks and obtains relief from the automatic stay to foreclose on Greenacre, which it does.[100] Because foreclosure is a taxable realization event, the debtor now has income equal to the difference between her adjusted basis in the property, $50,000, and the amount of the loan that is satisfied in the foreclosure, which we will assume is the full amount of $400,000. Thus, the debtor has a $350,000 gain on the foreclosure. Should this gain also be treated as discharge of indebtedness income? This article proposes that it should, because again the debtor is under the jurisdiction of the court in a bankruptcy proceeding at the time that the foreclosure occurs. Thus, the debtor will be required to reduce her tax attributes by the $350,000 discharge of indebtedness amount recognized on the foreclosure of Greenacre.

It is the third scenario that raises more difficult interpretive issues with respect to whether the discharge of indebtedness rules should apply to post-petition appreciation. This scenario arises when the post-petition appreciation is not recognized for tax purposes until after the termination of the bankruptcy proceeding. For example, in the previous scenario the secured creditor foreclosed on Greenacre while the bankruptcy proceeding was still pending. Should the result be different if the judge refused to lift the automatic stay, so that the secured creditor did not foreclose on Greenacre until after the termination of the proceeding? Under existing law, the discharge of indebtedness rules for bankruptcy proceedings apply only while the debtor is under the jurisdiction of a court in a Title 11 proceeding.[101] Thus, under current law the result in this scenario would be different than in the preceding one, and the debtor would be required to recognize the $350,000 of gain as income at the time of the foreclosure.[102]

Because the substance of the transactions in scenarios two and three is indistinguishable, and the only fact differentiating the two is when the foreclosure occurs, I contend that they should be treated alike for tax purposes. Accordingly, the debtor should have $350,000 of discharge of indebtedness income when the secured creditor forecloses on Greenacre at the termination of the bankruptcy proceeding, and she should be entitled to reduce her tax attributes by a like amount.

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99. *See, e.g.*, *In re* Nevin, 135 B.R. 652, 653 (Bankr. D. Haw. 1991) (citing Mason v. Comm'r, 68 T.C. 163 (1977), *aff'd*, 646 F.2d 1309 (9th Cir. 1980) (per curiam)).

100. For the grounds for seeking relief from the automatic stay in bankruptcy, see 11 U.S.C. § 362(d) (Supp. V 2005).

101. *See* I.R.C. § 108(a)(1)(A).

102. It should be made clear at this juncture that in the previous scenario the gain would only be treated as discharge of indebtedness income because my paradigm treats it as such; current law does not go that far, and only treats discharged debt as discharge of indebtedness income. It does not treat gain from the sale or disposition of property, even in a bankruptcy proceeding, as discharge of indebtedness income.

The final scenario raises the most difficult interpretive issues, however. In this final scenario, assume that the debtor and the secured creditor enter into a reaffirmation agreement with respect to the loan securing Greenacre[103] (or that the debtor is not in default on the loan and the ride through option has survived BAPCPA[104]). Thus, the creditor does not foreclose on the property either during the bankruptcy proceeding or immediately after it terminates. The debtor remains current on her loan payments for a number of months after bankruptcy, and the value of Greenacre rises to $500,000. She then suffers a series of financial reversals, fails to make several loan payments in a row, and the secured creditor forecloses on Greenacre to satisfy its loan. Should the debtor still be entitled to treat the gain as discharge of indebtedness income and, if so, should it include all of the gain inherent in the property (now $450,000), or merely the $350,000 gain inherent in the property at the termination of the bankruptcy case?

The purpose of allowing the debtor to treat gain on the sale or disposition of an asset as discharge of indebtedness income, thereby availing himself of the Title 11 exception to the discharge of indebtedness rules and postponing the recognition of gain, is to further the debtor's fresh start in bankruptcy. Therefore, it seems incongruous to allow the debtor to continue to use that exception many years after the bankruptcy proceeding has terminated, simply because the property at issue was once part of the bankruptcy proceeding. Yet to draw a bright line and suggest that the discharge of indebtedness exception is unavailable to a debtor after bankruptcy also leads to incongruous results, as scenarios two and three above demonstrate (foreclosure during or immediately after the bankruptcy proceeding). Accordingly, this article proposes a concept similar to an "exit tax," which is currently being proposed for expa-

103. For the requirements for entering into a reaffirmation agreement, see 11 U.S.C. § 524(c)-(d) (Supp. V 2005).

104. Ride-through allows a debtor who is current on his secured debt to neither redeem the collateral securing the debt nor reaffirm the debt, but instead allows the debtor to retain the property securing the debt by continuing to make timely payments on the debt. Whether the Bankruptcy Code permitted ride-through prior to the enactment of BAPCPA was subject to contentious debate among the circuits. *See, e.g.*, *In re* Price, 370 F.3d 362, 379 (3d Cir. 2004) (permitting ride-through); Capital Comm. Fed. Credit Union v. Boodrow (*In re* Boodrow), 126 F.3d 43, 51 (2d Cir. 1997) (permitting ride-through); *but see* Bank of Boston v. Burr (*In re* Burr), 160 F.3d 843, 849 (1st Cir. 1998) (limiting debtor's options to redemption or reaffirmation and rejecting the ride-through option); *In re* Edwards, 901 F.2d 1383, 1387 (7th Cir. 1990) (limiting debtor's options to redemption or reaffirmation and rejecting the ride-through option).

Although Congress intended to put an end to the ride-through option in BAPCPA, there is considerable debate over whether it was successful in doing so. For a comprehensive discussion of the ride-through option both before and after BAPCPA, see Jean Braucher, *Rash and Ride-Through Redux: The Terms For Holding on to Cars, Homes and Other Collateral Under the 2005 Act*, 13 AM. BANKR. INST. L. REV. 457, 474-82 (2005).

triates who renounce their United States citizenship and move to another country.[105]

Under this proposal, just before a debtor's bankruptcy estate is terminated, the bankruptcy judge will value all of the debtor's property that still remains in the bankruptcy estate or that has been abandoned back to the debtor.[106] Any gain inherent in that property will be treated as discharge of indebtedness income at the time of the valuation (there will be a fictional sale to creditors for the property's fair market value).[107] Yet because the debtor remains under the jurisdiction of the bankruptcy court, the discharge of indebtedness income will not be taxed to the debtor currently, but will instead reduce his tax attributes by a like amount. Moreover, the amount treated as discharge of indebtedness income must increase the debtor's basis in his asset producing that income, so that the gain is not taxed again to the debtor when he later sells or disposes of that asset.[108] This proposal will allow all pre-petition gain inherent in an asset upon the filing of a bankruptcy petition, together with all post-petition gain accruing to an asset during the pendency of the proceeding, to be treated as discharge of indebtedness income, irrespective of when the realization event with respect to that property occurs. At the same time, it recognizes that a line must be drawn, so that if the debtor retains an asset after the termination of the bankruptcy proceeding, he cannot

105. *See, e.g.*, H. 4297, 109th Cong. § 442 (2006) (generally taxes expatriates as having sold all of their assets at fair market value immediately prior to expatriation, and taxes them on the gain or loss immediately, without regard to other provisions of the Tax Code, such as otherwise applicable non-recognition provisions).

106. This proposal requires the bankruptcy judge to engage in a second valuation proceeding for all estate property. It can be criticized as adding additional expense to the bankruptcy process. Yet the cost of not doing so is to allow a debtor to treat too much income as discharge of indebtedness income, thereby reducing tax revenue in the long run. Accordingly, whenever a proposal attempts to harmonize competing tax and bankruptcy policies, the additional costs on one side (here, the valuation proceedings) must be weighed against the additional benefits on the other (here, increased tax revenue).

107. Under the Tax Code, there are a number of instances in which there is a fictional sale of property at its fair market value for tax purposes. *See, e.g.*, I.R.C. §§ 311(b)(1), 336(a) (2000). Moreover, the National Bankruptcy Review Commission proposed a similar concept when it suggested that if a trustee abandons property during the administration of a bankruptcy proceeding, it should be treated as a disposition of the property by the debtor immediately before bankruptcy. *See* NAT'L BANKR. REVIEW COMM'N, *supra* note 52, at 970. While the proposal in this article differs from the Commission's suggestion that there be a deemed sale of the abandoned property at the beginning of the bankruptcy proceeding because it suggests a deemed sale at the conclusion of the proceeding, the concept of a deemed sale remains the same in both proposals.

108. There are numerous examples in the Tax Code that allow a taxpayer to increase the basis in her assets by gain recognized, in order to prevent that gain from being taxed again. *See, e.g.*, I.R.C. §§ 358(a)(1)(B)(ii), 1031(d).

avail himself of the discharge of indebtedness exception forever, simply because the property was at one time property in the debtor's bankruptcy estate. Accordingly, gain accruing after the termination of the bankruptcy proceeding will be taxed to the debtor upon the sale or disposition of the property under normal tax principles.[109]

To illustrate this proposal, return one final time to the Greenacre example. Assume that the property is subject to a $400,000 lien, and therefore the trustee has abandoned the property back to the debtor. The property has increased in value to $400,000 at the termination of the bankruptcy proceeding, and the judge values it at $400,000. The debtor has entered into a reaffirmation agreement with the secured creditor and thus retains Greenacre. At the termination of the proceeding, the debtor will have $350,000 of discharge of indebtedness income (the fair market value of $400,000, which is the amount realized on a fictional sale of the property to creditors, less Greenacre's adjusted basis of $50,000). The debtor will not be required to include that $350,000 in gross income, but instead will decrease her tax attributes, such as her net operating losses and capital loss carryovers, by $350,000. She will be entitled to increase her basis in Greenacre by the amount of discharge of indebtedness income so that she is not required to pay tax on that gain again when she ultimately sells or disposes of Greenacre. Thus, its basis is increased by $350,000 to $400,000. If Greenacre appreciates another $100,000 in value before the debtor sells it (or it is foreclosed on by the secured creditor), that $100,000 gain will be taxed to the debtor as gross income, just as with any other sale or disposition.

V. CONCLUSION

One of the most exciting aspects of legal scholarship is engaging in scholarly debate with other academics. This article is the result of one such debate. Although the three-pronged proposal to solving the abandonments problem that I outlined in *Abandonments in Bankruptcy* created a strong foundation for resolving the issue, it required further analysis. This article goes one step further and considers the issue of how to treat post-petition appreciation in an asset for tax purposes when a debtor has availed herself of the bankruptcy process. Together, these articles attempt to propose a paradigm to be applied to the abandonments issue that will harmonize competing tax and bankruptcy policies and ultimately improve the bankruptcy system.

109. *See supra* notes 38-44 and accompanying text.