

Tying Together the Tax and Bankruptcy Codes: What Is the Proper Tax Treatment of Abandonments in Bankruptcy?

I. INTRODUCTION

To many people, the Internal Revenue Code¹ and the Bankruptcy Code² are quite separate and distinct. In law school, the tax and bankruptcy courses are taught separately, and there are very few, if any, overlapping issues discussed in the courses. In the real world, however, things are not so simple and discreet. Tax issues are often, or should be, the driving factor in many bankruptcy decisions. Many debtors, trustees in bankruptcy, and even lawyers fail to consider the profound effect that taxation may have in a bankruptcy situation. Taxation affects not only the debtor filing for bankruptcy relief but also the unsecured creditors.

Unfortunately, the answers to many bankruptcy-tax questions are not to be found in either of the Codes. In some cases, the two Codes provide opposite answers. Congress attempted to address this problem with the Bankruptcy Tax Act in 1980.³ While this Act resolved many issues regarding the reconciliation of the two Codes, the income tax consequences of the transfer of fully encumbered property between the debtor and the bankruptcy estate still present a difficult issue for the individual debtor, the trustee, the creditor, and the Internal Revenue Service. This Comment addresses the tax treatment of a specific type of transfer—abandonment of property by a trustee in bankruptcy back to a debtor.⁴

To illustrate the situation, suppose that Mary has recently had financial difficulty. She already took out a second mortgage on her house, so that now her house is fully encumbered. Unfortunately, even the money that Mary received from the second mortgage could not help her fully recover from her financial slump. As a result, Mary contacted an attorney and filed a petition for relief under Chapter 7 of the Bankruptcy Code. Immediately upon filing the bankruptcy petition, all of Mary's property was automatically transferred to an entity known as a bankruptcy estate,⁵ which is administered by a trustee in bankruptcy.

¹ I.R.C. §§ 1-9602 (1988).

² 11 U.S.C. §§ 101-1330 (1988).

³ Bankruptcy Tax Act of 1980, I.R.C §§ 1398-1399 (1988).

⁴ The discussion of the tax issues contained in this Comment has not been affected by the Reconciliation Act of 1993. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312 (1993).

⁵ 11 U.S.C. § 541 (1988).

The trustee, upon taking an "inventory" of the property of the estate, decides that Mary's house is worthless to the estate, because it is fully encumbered. That means that the trustee could spend a considerable amount of time and money trying to sell the house only to get nothing out of it for the estate (*i.e.*, for the unsecured creditors); any money received from the sale would go to the mortgagees to pay off the two mortgages on the house. So, the trustee decides to abandon the property back to Mary. Does this abandonment constitute a "sale or exchange" upon which the estate is taxed? Mary would like the estate to bear the tax burden so that she will not have to pay it when she later disposes of the property. The trustee, on the other hand, abandoned the property so that the estate could avoid spending the money to liquidate it—only to have the estate incur a tax liability with regard to the property.

This situation is certainly not atypical. Debtors in financial trouble often have property that is fully or over encumbered. Trustees in bankruptcy commonly react by abandoning the property, but the tax consequences of such a decision are far from certain. How can a debtor or a trustee in bankruptcy effectively plan for the tax consequences of an abandonment in the midst of such uncertainty?

This Comment attempts to address some of these concerns. First, this Comment provides a general overview of the taxation of individuals in bankruptcy, including the creation of a separate taxable bankruptcy estate, the tax consequences of discharge of indebtedness, and the tax treatment of dispositions of property in general. Second, this Comment looks at the tax implications of abandonment by a trustee in bankruptcy. In doing so, it analyzes the two opposing theories regarding the taxation of abandonments—the entrapment theory and the deflection theory. Finally, this Comment discusses the proper tax treatment of abandonments, adopting a middle approach that not only deals with the problems inherent in the two opposing theories but also attempts to reconcile the two Codes.

II. TAXATION OF INDIVIDUALS IN BANKRUPTCY IN GENERAL

A. *Creation of a Separate Taxable Bankruptcy Estate*

To understand the tax issues raised by abandonments, it is necessary to analyze the basic tax treatment of the transactions involved in bankruptcy and how the relevant Bankruptcy Code and Internal Revenue Code sections apply to those transactions.

The filing of a petition in bankruptcy creates an estate consisting of all legal and equitable interests of the debtor in property as of the commencement

of the case.⁶ A separate estate is created for bankruptcy law purposes regardless of whether the debtor is an individual, a corporation, or a partnership. However, for tax law purposes, the bankruptcy estate is treated as a separate taxable entity only for individuals filing under Chapter 7 (relating to liquidations) or Chapter 11 (relating to reorganizations) of the Bankruptcy Code.⁷ No separate taxable entity is created when either corporations or partnerships file for bankruptcy.⁸ Because of the lack of a separate taxable entity for corporations and partnerships, the problem of abandonments discussed in this Comment applies only to individuals in Chapter 7 or Chapter 11 proceedings.

The filing of the bankruptcy petition also operates as an automatic stay.⁹ The automatic stay prevents all creditors from attempting to satisfy their claims against either the debtor or the estate.

Section 1398 of the Internal Revenue Code provides that “[a] transfer (*other than by sale or exchange*) of an asset from the debtor to the estate [at the commencement of the bankruptcy case] shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition”¹⁰ This language implies that transfers that *do* constitute sales or exchanges *are* treated as taxable dispositions. It is quite conceivable that the transfer of encumbered property from the debtor to the estate upon commencement of the bankruptcy case could constitute a sale or exchange. As such, it would be excepted from the tax-free treatment of section 1398.¹¹ However, it seems unlikely that Congress intended transfers of encumbered property that occur by operation of law at the inception of a bankruptcy case to trigger recognition of gain or loss to the debtor.¹²

⁶ 11 U.S.C. § 541(a)(1) (1988). It is generally held that title to all of the debtor’s property vests in the bankruptcy estate upon commencement of the case. *See, e.g., In re Robison*, 74 B.R. 646, 647 (E.D. Mo. 1987).

⁷ I.R.C. § 1398(a) (1988).

⁸ *Id.* § 1399.

⁹ 11 U.S.C. § 362(a) (1988).

¹⁰ I.R.C. § 1398(f)(1) (1988) (emphasis added).

¹¹ *See, e.g., In re Rasmussen*, 95 B.R. 657, 658–59 (Bankr. W.D. Mo. 1989) (holding that debtors’ transfer of property to their bankruptcy estate in return for discharge of debts constituted an exchange for tax purposes).

¹² In fact, nonrecognition of gains or losses on such transfers appears to be universally accepted. *See, e.g., Rev. Rul. 78-134*, 1978-1 C.B. 197; *Priv. Ltr. Rul. 90-17-075* (Apr. 27, 1990); Martin S. Allen, *Selected Tax Considerations in Workouts and Bankruptcies*, in REAL ESTATE WORKOUTS AND BANKRUPTCIES 1992, at 119 (PLI Real Estate and Practice Course Handbook Series No. 379, 1992); Ray D. Madoff, *The Tax Consequences of Bankruptcy*, in TAX ASPECTS OF WORKOUTS, INSOLVENCY, AND BANKRUPTCY 1991, at 249 (ALI-ABA Course of Study Series No. c701, 1991); Richard C. Onsager, *Assigning Tax*

Consistent with the succession by the estate to the debtor's assets upon the commencement of the bankruptcy case, the Internal Revenue Code also provides that the estate succeeds to the following tax attributes of the debtor: (1) net operating loss carryovers, (2) charitable contributions carryovers, (3) recovery of tax benefit items, (4) credit carryovers, (5) capital loss carryovers, (6) basis, holding period, and character of assets, (7) method of accounting, and (8) other tax attributes as provided in the regulations.¹³

As with transfers at the commencement of the bankruptcy case, the Internal Revenue Code provides that, in general, transfers from the estate back to the debtor at the termination of the estate are not treated as dispositions for tax purposes.¹⁴ In addition, the Internal Revenue Code provides for the return of unused tax attributes from the estate to the debtor at the termination of the estate.¹⁵

B. Tax Implications to Debtor of Discharge of Indebtedness and Dispositions of Property

1. Discharge of Indebtedness—Section 108

Nearly everyone has debts, whether they are credit card debts, home mortgages, or student loans. Few would complain if their creditors were to call and tell them that they no longer owed anything—that their creditors were

Liability Between the Bankruptcy Estate and the Individual Debtor, 75 J. TAX'N 102, 102 (1991). What constitutes a sale or exchange for tax purposes will be discussed in further detail. See discussion *infra* part I.B.2.b.

¹³ I.R.C. § 1398(g) (1988). On November 9, 1992, proposed regulations under § 1398 were issued. The proposed regulations provide for the succession by the estate of two additional tax attributes—passive activity losses and losses suspended under the at-risk rules of § 465. Prop. Treas. Reg. §§ 1.1398-1(c), -2(c), 57 Fed. Reg. 53300-02 (1992).

These regulations have helped to clarify the substantial uncertainty created by § 1398 for the bankruptcies of individuals owning rental real estate and other properties subject to the passive loss and at-risk rules. Richard M. Lipton, *Proposed 1398 Regs. Raise Conflict Between Debtors and Bankruptcy Trustees*, 79 J. TAX'N 12 (1993). In this article, the author noted that the court in *In re Antonelli*, 150 B.R. 364 (Bankr. D. Md. 1992), held that absent regulations under § 1398(g), a debtor's passive losses would not be transferred to the bankruptcy estate. Lipton, *supra*, at 13. The Internal Revenue Service subsequently followed this holding. Priv. Ltr. Rul. 93-04-008 (Oct. 27, 1992). The author then commended the Service "for correcting the two most glaring omissions in Section 1398(g)." Lipton, *supra*, at 13.

¹⁴ I.R.C. § 1398(f)(2) (1988). See *infra* text accompanying notes 136–38, 149–50 for a discussion of what is meant by the phrase "termination of the estate."

¹⁵ *Id.* § 1398(i).

simply canceling their debt. However, such a generous act may carry with it some not-so-generous tax consequences.

In general, a cancellation of a debt occurs when a creditor accepts less than the unpaid balance of the debt in complete satisfaction of the liability, or when a creditor simply cancels the debt. A taxpayer does not realize income when money is borrowed, because there is an offsetting obligation to repay the amount.¹⁶ However, if the taxpayer is not required to repay the borrowed money, which relieves the borrower of an outstanding liability, ordinary income will result.¹⁷ The taxpayer is, in effect, being treated as having received money directly from the creditor.

Section 108 of the Internal Revenue Code provides that, in certain circumstances, a taxpayer may exclude from gross income that income arising from discharge of indebtedness.¹⁸ The most relevant exception for purposes of this Comment is the one that excludes discharge of indebtedness income if the discharge occurs in a Title 11 bankruptcy case.¹⁹

There is, however, a price to pay for the section 108 exclusion. The debtor must reduce certain tax attributes to the extent that discharge of indebtedness income is excluded.²⁰ The debtor may, however, elect to reduce first the basis

¹⁶ J. MARTIN BURKE & MICHAEL K. FRIEL, *TAXATION OF INDIVIDUAL INCOME* 54 (2d ed. 1992); William J. Rohrbach, Jr., *The Disposition of Properties Secured by Recourse and Nonrecourse Debt*, 41 BAYLOR L. REV. 231, 250 (1989).

¹⁷ I.R.C. § 61(a)(12) (1988). "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . . [i]ncome from discharge of indebtedness[.]" *Id.*; see also *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931) (holding that discharge of indebtedness income arose when a corporation repurchased its own bonds for an amount less than the price for which it sold those bonds).

¹⁸ I.R.C. § 108(a)(1) (1988).

¹⁹ *Id.* § 108(a)(1)(A).

²⁰ *Id.* § 108(b)(1). Tax attributes are to be reduced in the following order:

- (1) the net operating loss and any net operating loss carryover for the taxable year of discharge,
- (2) any carryover of the general business credit under § 38,
- (3) the net capital loss and any net capital loss carryover for the taxable year of discharge under § 1212,
- (4) the basis of the taxpayer's assets,
- (5) foreign tax credit carryovers.

Id. § 108(b)(2). A debtor may not reduce the basis in assets below the amount of any remaining undischarged liabilities. *Id.* § 1017(b)(2).

The tax attribute reductions are made after the determination of the tax for the taxable year of discharge. *Id.* § 108(b)(4)(A). The effect of this provision is to allow the

in depreciable property.²¹ This election provides flexibility to the debtor to account for discharge of indebtedness income in the most favorable manner. For example, a debtor who wishes to retain net operating losses and other carryovers may elect instead to reduce the basis in depreciable assets. Conversely, a debtor who has a net operating loss that is about to expire may apply discharge of indebtedness income first to reduce the net operating loss that would otherwise be wasted.²²

The timing of the tax attribute reduction provides the debtor another opportunity to engage in some tax planning. Tax attributes are reduced *after* the debtor calculates the tax liability for the year in which the debt is forgiven.²³ Thus, the reduction in tax attributes that is required by a debt reduction will not adversely affect gains on sales that occur during the same year as the debt reduction. The debtor can, therefore, sell property during the year of the debt reduction and use the full value of the net operating losses, tax basis, and the like to offset any gain realized.

Thus, section 108 does not permanently exclude income, but rather permits a taxpayer, in effect, to defer the discharge of indebtedness income by reducing various tax attributes. In doing so, this provision helps to reconcile the purposes of the Internal Revenue Code and the Bankruptcy Code. First, it helps to preserve the debtor's fresh start after bankruptcy by not burdening him with immediate tax liability. Second, it helps to preserve the government's interest in collecting tax revenue by merely deferring, not eliminating, the recognition of discharge of indebtedness income.²⁴

taxpayer to utilize existing attributes for transactions occurring in the year in which the benefit of § 108 is claimed.

²¹ *Id.* § 108(b)(5). Unlike the limitation placed on reduction of basis under § 108(b)(2), § 108(b)(5) permits a debtor to reduce the entire basis of depreciable property, but not below zero. *Id.* §§ 108(b)(5)(B), 1017(b)(2). Any discharge of indebtedness income remaining after the debtor's basis in depreciable property is reduced to zero must be applied to reduce the tax attributes in the order provided in § 108(b)(2). *See id.* § 108(b)(5)(C).

²² S. REP. NO. 1035, 96th Cong., 2d Sess. 10 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7025; H.R. REP. NO. 833, 96th Cong., 2d Sess. 9 (1980).

²³ I.R.C. § 108(b)(4)(A) (1988).

²⁴ S. REP. NO. 1035, *supra* note 22, at 10, *reprinted in* 1980 U.S.C.C.A.N. at 7025; H.R. REP. NO. 833, *supra* note 22, at 9 .

2. Dispositions of Encumbered Property

a. Tax Treatment of Dispositions in General

Debt may also be discharged in connection with the transfer of all or a portion of the debtor's property from the debtor to the creditor by foreclosure or by a deed in lieu of foreclosure. Such a transfer is generally treated as a taxable sale.²⁵ The gain from such a sale is equal to the excess of the amount realized over the adjusted basis.²⁶ The amount realized is equal to the sum of any money received plus the fair market value of property received.²⁷ The amount realized also includes all liabilities from which the debtor is relieved as a result of the transfer, but does not include amounts that would be treated as discharge of indebtedness income.²⁸ The calculation of the amount realized depends on whether the debt securing the property transferred is recourse (*i.e.*, one for which the debtor is personally liable) or nonrecourse (*i.e.*, one for which the debtor is not personally liable).

If the debt is recourse, the regulations adopt a bifurcated approach. The gain is measured by the difference between the property's adjusted basis and its fair market value. If the amount of recourse debt exceeds the fair market value of the property, and the debtor is relieved of a personal obligation by transferring the property, then the difference between the amount of the debt and the fair market value of the property is treated as discharge of indebtedness income.²⁹ This bifurcated approach may be preferable to the debtor in bankruptcy, because recognition of at least part of the gain realized from the transfer of the property may be deferred under section 108 of the Internal Revenue Code.³⁰ In addition, if the property transferred qualifies as a capital asset, the debtor may benefit from capital gain treatment of the remainder of the gain realized.³¹

²⁵ I.R.C. § 61(a)(3) (1988). *See infra* text accompanying notes 36–44.

²⁶ *Id.* § 1001(a).

²⁷ *Id.* § 1001(b).

²⁸ Treas. Reg. § 1.1001-2(a) (1980).

²⁹ *Id.* § 1.1001-2(a)(2), (c), Example 8. The IRS has confirmed the appropriateness of this bifurcated approach. Rev. Rul. 90-16, 1990-1 C.B. 12.

³⁰ *See supra* notes 18–24 and accompanying text.

³¹ *See* Timothy A. Larason, *Even Insolvent Taxpayers Have Income When Property is Abandoned*, 45 TAX'N FOR ACCT. 88, 89 (1990) (stating that one could imply from the fact that the Senate Report to the Bankruptcy Tax Act of 1980 specifically precludes the possibility of converting the excluded discharge of indebtedness income from ordinary income to capital gain that any income that would otherwise be treated as capital gain would not qualify for the exclusion). *See* I.R.C. § 1221 for the definition of a capital asset.

If, on the other hand, the debt is nonrecourse, the entire amount of the indebtedness discharged in return for the foreclosure of the property securing the indebtedness is treated as amount realized.³² This treatment is mandated even if the fair market value of the property is less than the amount of the indebtedness.³³ Thus, none of the gain is treated as discharge of indebtedness income. It may, however, be possible to bifurcate the transaction itself into two steps: "(i) forgiveness of a portion of the indebtedness without consideration and (ii) a subsequent satisfaction of the remainder of the indebtedness by the transfer of the property."³⁴ It may also be possible to convert the nonrecourse debt into recourse debt before transferring the property so that the bifurcation approach to recourse debt applies.³⁵

b. Case Law Characterizing Dispositions

At this point, a discussion of the case law relevant to the taxation of dispositions and the definition of what constitutes a disposition for tax purposes is helpful.³⁶

When a debtor sells property encumbered by a recourse obligation and the purchaser assumes this obligation, it is generally held that the total amount of the obligation assumed is included in the debtor's amount realized.³⁷ This treatment is required because the debtor receives a benefit to the extent the debtor is relieved of a personal obligation to pay money.³⁸

³² Treas. Reg. § 1.1001-2(a)(4)(i) (1980).

³³ *Commissioner v. Tufts*, 461 U.S. 300, 317 (1983); Treas. Reg. § 1.1001-2(c), Example 7 (1980).

³⁴ Roger M. Ritt & Robert D. Burke, *Selected Tax Issues in Workouts and Bankruptcies: Debt Forgiveness, Foreclosures, and Modifications*, in TAX AND BUSINESS PLANNING 1991, at 171 (ALI-ABA Course of Study Series No. c605, 1991); see also Michael G. Frankel, *Tax Planning for Troubled Real Estate and Partnership Transactions—Part 2*, 20 J. REAL EST. TAX'N 6, 7 (1992).

³⁵ Frankel, *supra* note 34, at 10; Ritt & Burke, *supra* note 34, at 175.

³⁶ See Rohrbach, *supra* note 16, at 234–44 (discussing *Crane v. Commissioner* and its progeny at length). It is important to note that the cases discussed in this section involved dispositions in *nonbankruptcy* situations. They will, however, be relevant to the discussion of whether abandonment in bankruptcy is a taxable disposition. See discussion *infra* part III.C.1.c.

³⁷ See *Crane v. Commissioner*, 331 U.S. 1, 13 (1947). This necessarily affects the amount of the gain realized by the debtor. Keeping the basis constant, the higher the amount realized, the higher the gain will be. See *supra* notes 26–28 and accompanying text.

³⁸ *Crane*, 331 U.S. at 13.

The Supreme Court has consistently held that a liability of a seller, assumed by a purchaser, is included in the seller's amount realized—even when the liability is nonrecourse³⁹ and even when the amount of the nonrecourse liability exceeds the fair market value of the property sold.⁴⁰ In each case, the Supreme Court based its finding on the fact that the seller received a benefit by being relieved of the liability.⁴¹

Other cases have held that there need not be a voluntary sale and assumption of a liability for this analysis to apply. Relief from a liability in an involuntary foreclosure sale,⁴² a reconveyance of property back to the creditor in satisfaction of the debt,⁴³ and abandonment of property⁴⁴ have all been held to sufficiently benefit the debtor so as to give rise to an amount realized.

c. *Effect of Bankruptcy on Who Bears the Burden of the Tax*

Whether the estate or the debtor is to be liable for the payment of taxes on the sale of property before or during the bankruptcy case can have a dramatic impact on the debtor, the unsecured creditors, the trustee in bankruptcy, and the Internal Revenue Service. If a creditor forecloses on the debtor's property before the bankruptcy petition is filed, the transaction is treated just like any other nonbankruptcy transfer and, therefore, is taxable to the debtor. This tax will most likely be nondischargeable in bankruptcy.⁴⁵ If, however, the creditor forecloses on the property after the debtor files for bankruptcy, the estate will be liable for the tax on any gain.⁴⁶ This tax will be an administrative expense⁴⁷

³⁹ *Id.* at 14.

⁴⁰ *Commissioner v. Tufts*, 461 U.S. 300, 317 (1983).

⁴¹ *Id.* at 312; *Crane*, 331 U.S. at 14.

⁴² *Helvering v. Hammel*, 311 U.S. 504 (1941).

⁴³ *Freeland v. Commissioner*, 74 T.C. 970 (1980); *see also* *Millar v. Commissioner*, 577 F.2d 212 (3d Cir. 1978) (holding that a surrender of stock in exchange for cancellation of indebtedness resulted in realization of taxable gains); Rev. Rul. 78-164, 1978-1 C.B. 264.

⁴⁴ *Yarbro v. Commissioner*, 737 F.2d 479 (5th Cir. 1984), *cert. denied*, 469 U.S. 1189 (1985); *see also* *Middleton v. Commissioner*, 693 F.2d 124 (11th Cir. 1982) (holding that when owners volunteered to deed property subject to nonrecourse debt back to the mortgagee, such action resulted in abandonment of property, which constituted a sale or exchange). Note that both of these cases dealt with *nonbankruptcy* abandonments.

⁴⁵ 11 U.S.C. § 523(a)(1) (1988). Only if the tax was last due *more than* 3 years before the petition date or assessed *more than* 240 days before the petition date, will the tax be dischargeable to the debtor. *Id.* §§ 523(a)(1)(A), 507(a)(7)(A)(i)-(ii).

⁴⁶ Section 1398 of the Internal Revenue Code provides that “[t]he gross income of the estate for each taxable year shall include the gross income of the debtor *to which the estate is entitled* under title 11 of the United States Code.” I.R.C. § 1398(e)(1) (1988) (emphasis

and will be given first priority over other unsecured claims.⁴⁸ The debtor will not be liable for any deficiency if the estate's assets are insufficient to cover administrative expenses.⁴⁹

How do these results affect the parties involved?⁵⁰ First, the debtor will have a strong interest in ensuring that the estate is liable for the taxes. If the debtor is liable for the taxes, the debtor will probably emerge from the bankruptcy with a significant nondischargeable debt to the Internal Revenue Service, which, of course, severely limits the "fresh start" purpose of the Bankruptcy Code.⁵¹

Second, by treating gains taxable to the estate as a first priority administrative expense, funds available to pay unsecured creditors are significantly reduced. This severely limits a countervailing purpose of the Bankruptcy Code—to protect private, voluntary, unsecured creditors.⁵² The unsecured creditors will thus have a strong interest in avoiding any sale taxable to the estate.

Third, the trustee in bankruptcy also has an interest in keeping administrative tax expenses at a minimum. The trustee's fees are also

added). Because the estate is a separate taxable entity, and the estate itself made the transfer, it is entitled to the income from the transfer and, therefore, liable for any tax on such income. See also Frankel, *supra* note 34, at 39-40; Mark A. Wallace, *Is a Midstream Abandonment of Property by a Bankruptcy Trustee Taxable to the Estate?*, 77 J. TAX'N 26, 26 (1992).

⁴⁷ 11 U.S.C. § 503(b)(1)(B)(i) (1988). But see *infra* text accompanying notes 108-16.

⁴⁸ 11 U.S.C. § 507(a)(1) (1988).

⁴⁹ This result is implied from the fact that 11 U.S.C. § 523 does not except administrative expenses from discharge. Taxes incurred by the estate in the administration of its property (such as when a creditor forecloses on the property in the hands of the estate) are classified as administrative expenses, not taxes, for purposes of § 523 (discharge) and § 507 (priorities).

⁵⁰ This analysis of the interests of, and the effects on, the parties applies equally to the taxation of abandonments in bankruptcy.

⁵¹ See, e.g., *In re Lindberg*, 735 F.2d 1087, 1090 (8th Cir.), *cert. denied*, 469 U.S. 1073 (1984); *In re Sinder*, 102 B.R. 978, 989 (Bankr. S.D. Ohio 1989); *In re Weatherspoon*, 101 B.R. 533, 541 (Bankr. N.D. Ill. 1989) (citing *Lines v. Frederick*, 400 U.S. 18, 19 (1970)); *In re Laymon*, No. 6-89-235, 1989 WL 252447 (D. Minn. July 25, 1989); S. REP. NO. 1035, *supra* note 22, at 10, *reprinted in* 1980 U.S.C.C.A.N. at 7025 (1980); H.R. REP. NO. 833, *supra* note 22, at 9; S. REP. NO. 989, 95th Cong., 2d Sess. 13-14 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5799.

⁵² S. REP. NO. 989, *supra* note 51, at 14, *reprinted in* 1978 U.S.C.C.A.N. at 5800; see also Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 824-28 (1987) (arguing that placing additional burdens on creditors in bankruptcy invites troublesome forum shopping, with creditors seeking to enforce their claims in a nonbankruptcy setting).

administrative expenses; as such, they are afforded the same priority as taxes.⁵³ The trustee will not want to reduce the amount available to pay these fees by engaging in taxable transactions on behalf of the estate. In addition, the trustee may remain personally liable for tax liabilities of the estate that remain unpaid.⁵⁴

Finally, the Internal Revenue Service has certain interests, somewhat different from those of the other parties, which must be protected. The tax system works only to the extent that taxpayers think it is fair. The integrity of the tax system, therefore, must not be jeopardized by permitting taxpayers to use bankruptcy as a means of improperly avoiding their tax debts and placing the burden of making up the lost revenues on other taxpayers.⁵⁵

III. TAX IMPLICATIONS OF ABANDONMENT

A. *The Trustee's Right to Abandon*

The Bankruptcy Code grants a trustee the authority to abandon an asset "that is burdensome to the estate or that is of inconsequential value and benefit to the estate."⁵⁶ A trustee is most likely to abandon property if the mortgage securing it exceeds the fair market value of the property. This property may be abandoned to any party with a possessory interest.⁵⁷

The legislative history to section 554 of the Bankruptcy Code is silent as to the purpose of the abandonment provision. Judges and commentators, however, have suggested that the purposes behind the abandonment provision are maximization of the estate for distribution to parties in interest and expeditious reduction of the debtor's property to money for such distribution.⁵⁸

⁵³ 11 U.S.C. § 503(b)(1)(A) (1988).

⁵⁴ Treas. Reg. § 301.6871(a)-2(c) (1967); Madoff, *supra* note 12.

⁵⁵ S. REP. NO. 989, *supra* note 51, at 14, *reprinted in* 1978 U.S.C.C.A.N. at 5800. In the case of bankruptcy, the unsecured creditors bear the burden of making up the lost revenues.

⁵⁶ 11 U.S.C. § 554(a) (1988).

⁵⁷ S. REP. NO. 989, *supra* note 51, at 92, *reprinted in* 1978 U.S.C.C.A.N. at 5878; H.R. REP. NO. 595, 95th Cong., 1st Sess. 377 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963.

⁵⁸ *In re Terjen*, 154 B.R. 456, 458 (E.D. Va. 1993); *In re Nevin*, 135 B.R. 652, 654 (Bankr. D. Haw. 1991); *In re Olson*, 121 B.R. 346, 348 (N.D. Iowa 1990), *aff'd*, 930 F.2d 6 (8th Cir. 1991); M. BIENENSTOCK, *BANKRUPTCY REORGANIZATION* 340 (1987); L. KING, 4 *COLLIER ON BANKRUPTCY* ¶ 554.01 (15th ed. 1985).

B. *The Tax Issue*

The Bankruptcy Tax Act of 1980⁵⁹ and its legislative history⁶⁰ are silent with regard to the tax treatment of abandonments in bankruptcy. The Act does state that transfers from the estate to the debtor (other than by sale or exchange) at the termination of the estate are free from tax consequences.⁶¹ However, it is not clear whether the phrase, "at the termination of the estate," was intended by Congress to apply to midstream abandonments of property by a trustee in bankruptcy.⁶² As a result, determination of the applicability of this section has been left to judicial interpretation. Two specific issues must be addressed in determining whether an abandonment of property by a trustee in bankruptcy is taxable to the estate or to the debtor upon subsequent disposition of the property. These are as follows: (1) whether section 1398(f)(2), with its "termination of the estate" language, applies to abandonments during bankruptcy, and (2) whether abandonments themselves constitute sales or exchanges of the property, which would take them out of the purview of section 1398(f)(2) and give rise to taxable income. These issues will be addressed in conjunction with an analysis of the opposing theories regarding the taxation of abandonments in bankruptcy.

⁵⁹ I.R.C. §§ 1398–1399 (1988).

⁶⁰ S. REP. NO. 1035, *supra* note 22, at 28–32, reprinted in 1980 U.S.C.C.A.N. at 7045; H.R. REP. NO. 833, *supra* note 22, at 23–27.

⁶¹ I.R.C. § 1398(f)(2) (1988).

⁶² Compare *In re Olson*, 100 B.R. 458, 463 (Bankr. N.D. Iowa 1989), *aff'd*, 121 B.R. 346 (N.D. Iowa 1990), *aff'd*, 930 F.2d 6 (8th Cir. 1991) (stating that the court could see no reason why abandonment during bankruptcy should have a different tax effect) and *In re McGowan*, 95 B.R. 104, 107 (Bankr. N.D. Iowa 1988) (holding that "termination of the estate" includes the termination of the estate's interest in property by abandonment) with *In re A.J. Lane & Co.*, 133 B.R. 264, 273 (Bankr. D. Mass. 1991) (rejecting the reasoning of the *McGowan* and *Olson* courts) and Bradley J. Nelson, *Taxation of Abandonments in Bankruptcy*, 10 J. AGRIC. TAX'N & LAW 221, 226 (1988) (stating that "termination of the estate" clearly excludes abandonments).

C. Analysis of the Opposing Theories and Case Law

1. The Entrapment Theory

a. A Look at the Theory Itself

Under the entrapment theory, the abandonment is considered a taxable event triggering gain or loss, thereby "trapping" the tax in the estate.⁶³ The result of this entrapment is that the bankruptcy estate incurs a substantial tax liability⁶⁴ and the debtor receives a stepped-up basis (*i.e.*, fair market value) in the property when it is abandoned. Thus, if the creditor subsequently forecloses upon the property, the debtor will realize little or no gain.⁶⁵

The Internal Revenue Code specifically provides that transfers into the estate upon commencement of the bankruptcy case⁶⁶ and transfers out of the estate upon termination of the estate⁶⁷ are nontaxable events. However, the Internal Revenue Code is silent as to whether either of these provisions was intended to apply to abandonments of property during the administration of the case. Thus, the theory concludes, absent a specific statutory exemption, the general principles of tax law apply.⁶⁸

There are four major premises upon which the entrapment theory relies.⁶⁹ First, the transfer of property from the debtor to the estate at the commencement of the case is tax free and subject to the mortgage. If this premise were to fail, the theory would not work for two reasons: (1) if the transfer were not tax free, then the debtor would be taxed on any gain upon commencement of the case, the estate would receive a stepped-up basis in the property, and there would be no gain upon abandonment to trap in the estate; and (2) if the transfer were not subject to the mortgage, then the estate would receive no benefit (*i.e.*, relief from the mortgage indebtedness) by abandoning the property, and there could be no sale or exchange on which to justify taxing the estate. According to the theory, the Internal Revenue Code expressly

⁶³ See Nelson, *supra* note 62, at 226.

⁶⁴ This tax liability may be classified as a first priority administrative expense. 11 U.S.C. §§ 503(b)(1)(B)(i), 507(a)(1) (1988). The significance of this classification will be addressed later. See *infra* text accompanying notes 109–16.

⁶⁵ This result follows from the fact that gain is calculated as the excess of amount realized (theoretically, fair market value) over the debtor's adjusted basis (which, after the abandonment, is also fair market value). I.R.C. § 1001(a) (1988).

⁶⁶ *Id.* § 1398(f)(1).

⁶⁷ *Id.* § 1398(f)(2).

⁶⁸ These principles are embodied in I.R.C. §§ 61(a)(3), 1001.

⁶⁹ Nelson, *supra* note 62, at 227–28.

provides for nonrecognition of gain upon transfer from the debtor to the estate at the commencement of the case.⁷⁰ In addition, the transfer to the estate is subject to the mortgage, because the estate can only receive whatever interest the debtor had in the property.⁷¹ Because the property was subject to the mortgage in the debtor's hands, it must also be subject to the mortgage in the hands of the estate.

Second, the entrapment theory relies on the premise that upon the filing of a bankruptcy petition, the value of the secured creditor's mortgage or lien is stripped down to the fair market value of the property. Section 506 of the Bankruptcy Code achieves this result.⁷² This section operates to secure the creditor's mortgage only to the extent of the fair market value of the property that is subject to it. Any amount that exceeds the fair market value of the property is relegated to unsecured status. This premise is important because the secured portion of the mortgage essentially attaches to the property—it is not a personal debt; only the deficiency, or unsecured portion of the mortgage, may be considered personal debt. Thus abandonment of the property by the trustee in bankruptcy transfers not only the property but also the secured portion of the mortgage, which benefits the estate by relieving it of that debt.⁷³ The unsecured portion remains with the estate to be paid out of any funds remaining after all secured and priority claims are paid.

Third, the entrapment theory relies upon nonbankruptcy case law for the proposition that an abandonment constitutes a taxable exchange. This proposition rests on two major premises. First, the estate is relieved of the secured portion of the debt when it abandons the property. This benefit is sufficient to constitute an amount realized.⁷⁴ Second, the abandonment constitutes an exchange for tax purposes: the estate is (1) giving legal title to the property free and clear of the claims of unsecured creditors, (2) receiving a relief from its obligations to pay the secured portion of the debt associated with the property, and (3) there is a causal connection between the abandonment and the relief from the obligation.⁷⁵

⁷⁰ I.R.C. § 1398(f)(1) (1988).

⁷¹ 11 U.S.C. § 541(a)(1) (1988).

⁷² *Id.* § 506(a).

⁷³ This result, it will be shown, is important for purposes of showing that the estate incurs a taxable gain to the extent that its amount realized (*i.e.*, its relief from the secured debt) exceeds its adjusted basis. See *infra* notes 81-82 and accompanying text.

⁷⁴ See *Commissioner v. Tufts*, 461 U.S. 300, 312 (1983); *Crane v. Commissioner*, 331 U.S. 1, 14 (1947).

⁷⁵ This premise essentially applies the three-part definition of an "exchange." There must be "a giving, a receipt, and a causal connection between the two." *Yarbro v. Commissioner*, 737 F.2d 479, 483 (5th Cir. 1984), *cert. denied*, 469 U.S. 1189 (1985).

Fourth, the entrapment theory dictates that this tax be given administrative priority as an expense of the estate.⁷⁶ This treatment is necessary so that the tax does not pass out of the estate to the debtor at the termination of the case. The purpose of the entrapment theory is to trap the tax in the estate, which relieves the debtor of any tax liability resulting from the abandonment. If the tax liability is given administrative priority, the debtor will not be liable for any deficiency if the estate's assets are insufficient to cover administrative expenses.⁷⁷ If, on the other hand, the tax liability is not afforded administrative priority, the debtor will remain liable, which undermines the purpose of the entrapment theory.

b. *The Case Law Supporting the Entrapment Theory*

The main case that supports the entrapment theory is *In re A.J. Lane & Co.*⁷⁸ In this case, one of the creditors had been granted relief from the automatic stay and had scheduled foreclosure sales of the debtor's three apartment complexes. The trustee filed a notice of intention to abandon these properties to avoid the substantial income tax that would be incurred by the estate upon foreclosure.⁷⁹ The court held that the abandonment constituted a sale, taxable to the bankruptcy estate rather than the debtor.⁸⁰

In its reasoning, the court addressed three separate arguments. First, the court reasoned that the abandonment constituted a taxable sale or exchange. The court relied heavily on *Yarbro v. Commissioner*⁸¹ and held that because the

⁷⁶ 11 U.S.C. §§ 503(b)(1)(B)(i), 507(a)(1) (1988).

⁷⁷ See *supra* note 49 and accompanying text.

⁷⁸ 133 B.R. 264 (Bankr. D. Mass. 1991). The court in *In re Rubin* expressly adopted the reasoning set forth in *In re A.J. Lane*. *In re Rubin*, 154 B.R. 897, 899, 901 (Bankr. D. Md. 1992). In *In re Rubin*, certain unsecured creditors sought to compel abandonment of the debtor's partnership interest to avoid a court-approved settlement under which the partnership would transfer certain property to one of its creditors in satisfaction of its claim against the partnership. Because the gain from this transfer would pass through to the partnership interest holders, the estate would incur a large gain. The court denied the motion in part because under the reasoning of *In re A.J. Lane*, the estate could not escape taxation by abandoning the property to the debtor. *Id.* at 901. For an explanation and analysis of *In re A.J. Lane*, see Craig W. Friedrich, *Tax Consequences Taken into Account in Determining Whether to Allow Bankruptcy Trustee to "Abandon" Property*, 20 J. REAL EST. TAX'N 94 (1992); Wallace, *supra* note 46, at 27-30.

⁷⁹ *In re A.J. Lane*, 133 B.R. at 266.

⁸⁰ *Id.* at 275.

⁸¹ 737 F.2d 479 (5th Cir. 1984) (holding that relief of an obligation to repay a nonrecourse mortgage as a result of abandoning the property was sufficient to support a sale or exchange).

trustee conveyed property, and the estate was relieved of the secured portion of the debt, the estate received a benefit from abandoning the property, and the abandonment was taxable. It further noted that the facts of the present case were even more compelling than those of *Yarbro*, because the foreclosure sale was already scheduled to take place, whereas in *Yarbro*, the foreclosure sale was likely but not yet in process.⁸²

Second, the court reasoned that under *Commissioner v. Court Holding Co.*,⁸³ the trustee could not use the debtor as a mere conduit through which to pass title and transfer property already the subject of a sales transaction. Such a transfer would be for the sole purpose of having the debtor, rather than the estate, taxed on the sale.⁸⁴

Third, the court reasoned that abandonment does not escape taxation as a transfer at "the termination of the estate."⁸⁵ Section 1398(f)(2), providing that a transfer from the estate to the debtor at the termination of the estate is tax free, and section 1398(i), providing that the debtor succeeds to the tax attributes of the estate upon termination of the estate, must be read in conjunction with each other. Thus, the court reasoned, the statute anticipates a sort of symmetry: the party holding the property, and therefore subject to the tax burden, is also the one entitled to the tax attributes.⁸⁶ Because the estate still holds the tax attributes upon abandonment of the property, the estate must be the taxable entity.

Fourth, the court reasoned that taxing the debtor on the foreclosure following the abandonment would create a clear burden on the debtor's fresh start.⁸⁷ The creditors would not be significantly prejudiced if the gain were taxed to the estate, because the estate had inherited large net operating losses from the debtor. Thus, the fresh start policy of the Bankruptcy Code should prevail.⁸⁸

⁸² *In re A.J. Lane*, 133 B.R. at 271.

⁸³ 324 U.S. 331 (1945) (holding that a corporation cannot avoid taxation on a sale of property by conveying that property to its shareholders and using them as a mere conduit through which to pass title).

⁸⁴ *In re A.J. Lane*, 133 B.R. at 271. The court's reliance on the *Court Holding* doctrine could open the door to examination of the debtor's reasons for filing a bankruptcy petition in the first place. In other words, the debtor could have filed for bankruptcy to use the estate as a mere conduit through which to effectuate a pending foreclosure. That way the tax liability could be transferred to the estate. Wallace, *supra* note 46, at 30.

⁸⁵ I.R.C. § 1398(f)(2) (1988).

⁸⁶ *In re A.J. Lane*, 133 B.R. at 272.

⁸⁷ *Id.* at 274.

⁸⁸ *Id.*

c. *Problems Inherent in the Entrapment Theory*

There are several problems with the entrapment theory. The most serious problem is that the theory completely ignores bankruptcy law. It seems simple to conclude that absent a specific statutory exemption, the general principles of tax law apply to characterize the tax effects of abandonments in bankruptcy. However, one major point is forgotten: not only are we dealing with a tax issue but we are also operating in a bankruptcy context. Therefore, both the Internal Revenue Code and the Bankruptcy Code must be considered before arriving at a conclusion as to how to treat abandonments for tax purposes.

Under the Bankruptcy Tax Act, the estate is only responsible for gross income of the debtor to which the estate is "entitled."⁸⁹ The problem is that gross income to which the estate is entitled under the Bankruptcy Code is different from a recognition event under the Internal Revenue Code. The Internal Revenue Code requires recognition of a gain on appreciated property when there is (1) a sale or other disposition, and (2) an amount realized by the taxpayer.⁹⁰ However, in a bankruptcy setting, the entitled requirement must also be met.

What is meant by the term "entitled"? The term implies that one qualifies for, or has proper grounds for claiming, a right or benefit.⁹¹ Thus, it seems that one must *do* something before one can qualify for any benefits flowing from the action. It has been suggested that, in interpreting the entitled language, courts must apply the same analysis that is used to determine whether a tax has been "incurred by the estate" so as to be given administrative priority under section 503(b)(1) of the Bankruptcy Code.⁹² Applying this analysis, an estate is entitled to gross income when the trustee "administers" the estate.⁹³ In an abandonment, however, the trustee is not administering the estate.⁹⁴

⁸⁹ I.R.C. § 1398(e)(1) (1988).

⁹⁰ *Id.* § 1001(a)-(b).

⁹¹ See BLACK'S LAW DICTIONARY 532 (6th ed. 1991).

⁹² 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, 703-06 (1989).

⁹³ *Id.*; see also S. REP. NO. 989, *supra* note 51, at 66, reprinted in 1978 U.S.C.C.A.N. at 5852.

⁹⁴ See 11 U.S.C. § 554(c) (1988) (stating that a trustee can either abandon or administer the property); *In re Carlisle Court, Inc.*, 36 B.R. 209, 217 n.33 (Bankr. D.D.C. 1983) (stating that when property is abandoned by the trustee, any tax arising is not given administrative priority, because it is not "incurred by the estate"); see also Larason, *supra* note 31 (stating that the bankruptcy estate is not entitled to any income when there is an abandonment).

Therefore, the estate is not entitled to the income arising from the gain upon abandonment and, as a result, is not responsible for the income under section 1398(e)(1).

Another problem with the entrapment theory is that if an abandonment is treated as a sale or exchange, then consistency may mandate that similar treatment be afforded to the transfer from the debtor to the estate at the commencement of the case.⁹⁵ To determine whether this transfer must also be treated as a "sale or exchange," the *Yarbro* exchange analysis must be applied.⁹⁶

At the commencement of the case, the debtor is giving legal title to the bankruptcy estate.⁹⁷ But what is the debtor receiving? Arguably, the debtor is receiving nothing. Commencement of bankruptcy constitutes an order for relief.⁹⁸ However, the debtor will receive no relief from indebtedness until the date of the discharge at the close of the case.⁹⁹ Furthermore, there is the possibility that the debtor's bankruptcy case may be dismissed, that the bankruptcy court may deny a discharge, or that the trustee may abandon the property back to the debtor.¹⁰⁰

An alternate characterization is that, because the property is transferred to the estate subject to the mortgage, the debtor is being relieved of the obligation to make mortgage payments and pay property taxes.¹⁰¹ In effect, the debtor is being relieved of any obligation that is to be satisfied by the property (*i.e.*, the secured portion of the debt). This alternative is supported by section 506 of the Bankruptcy Code, which strips down the mortgage and treats as secured only that portion equal to the fair market value of the property. It is also supported

⁹⁵ I.R.C. § 1398(f)(1) describes the tax consequences of a transfer at the commencement of the case "other than by sale or exchange." Thus, if the transfer at the commencement of the case constitutes an exchange applying the same analysis as that applied to abandonments, then it would be excepted from I.R.C. § 1398(f)(1). See also Ray D. Madoff, *A Reappraisal of the Tax Consequences of Abandonments in Bankruptcy*, 50 TAX NOTES 785, 791 (1991); Nelson, *supra* note 62, at 233-35; Wallace, *supra* note 46.

⁹⁶ There must be "a giving, a receipt, and a causal connection between the two." *Yarbro v. Commissioner*, 737 F.2d 479, 483 (5th Cir. 1984), *cert. denied*, 469 U.S. 1189 (1985). Applying this analysis, of course, assumes that we are ignoring the first problem—that a recognition event in bankruptcy requires an entitlement—and are applying only general tax law in determining whether there has been a sale or exchange.

⁹⁷ See 11 U.S.C. § 541(a) (1988).

⁹⁸ *Id.* § 301.

⁹⁹ Nelson, *supra* note 62, at 233; Wallace, *supra* note 46, at 29.

¹⁰⁰ Wallace, *supra* note 46, at 29.

¹⁰¹ See *supra* note 71 and accompanying text.

by the case law, which defines "sale or exchange" rather broadly.¹⁰² Certainly, there is a causal connection between transferring property to the bankruptcy estate and relief from mortgage payments and property taxes. Thus, the transfer at the commencement of the case would constitute an exchange under nonbankruptcy law and would, therefore, be excepted from the tax-free treatment of section 1398(f)(1). This result is anomalous because, in practice, section 1398(f)(1) has not been applied in this manner.¹⁰³

A third problem with the entrapment theory is the characterization of the abandonment itself as a sale or exchange. The Internal Revenue Code generally taxes those dispositions that it deems final. Exceptions to taxation are made when the new property is substantially a continuation of the old investment. Thus, the appropriate time for taxation of a gain is upon final disposition of the property.¹⁰⁴ Upon commencement of the bankruptcy case, "the estate shall be treated as the debtor would be treated with respect to [each] asset,"¹⁰⁵ and upon termination of the case, "the debtor shall be treated as the estate would be treated with respect to [each] asset."¹⁰⁶ Thus, the Internal Revenue Code seems to provide for the continuation of the old investment. Filing a bankruptcy petition does not change the character or form of investment, nor does abandonment of property by the trustee in bankruptcy. Therefore, taxation should be reserved for final disposition of the property, namely foreclosure.¹⁰⁷

A final problem with the entrapment theory is that its main purpose is undermined by bankruptcy law regarding administrative priorities. As previously stated, the entrapment theory relies on the premise that the tax be given administrative priority so that the tax does not pass out of the estate to

¹⁰² See *Crane v. Commissioner*, 331 U.S. 1, 14 (1947) (holding that relief from obligation to pay taxes and assessments against property constitutes a benefit sufficient to give rise to an amount realized); see also *Commissioner v. Tufts*, 461 U.S. 300, 312 (1983); *Yarbro v. Commissioner*, 737 F.2d 479, 484 (5th Cir. 1984), *cert. denied*, 469 U.S. 1189 (1985); *Freeland v. Commissioner*, 74 T.C. 970, 981 (1980).

¹⁰³ See *supra* note 12 and accompanying text.

¹⁰⁴ See, e.g., *Helvering v. Hammel*, 311 U.S. 504, 512 (1941); *Commissioner v. Baertschi*, 412 F.2d 494, 498 (6th Cir. 1969); *Morco Corp. v. Commissioner*, 300 F.2d 245 (2d Cir. 1962); *Woodsam Assocs., Inc. v. Commissioner*, 198 F.2d 357, 359 (2d Cir. 1952); *Caplan v. United States*, 270 F. Supp. 203, 210 (S.D. Fla. 1966); *Danenberg v. Commissioner*, 73 T.C. 370, 385 (1979).

¹⁰⁵ I.R.C. § 1398(f)(1) (1988).

¹⁰⁶ *Id.* § 1398(f)(2).

¹⁰⁷ Note, however, that the usual situation is distinguishable from *In re A.J. Lane*. In that case, foreclosure proceedings (*i.e.*, final disposition) had already commenced when the trustee abandoned the property. *In re A.J. Lane*, 133 B.R. 264, 266 (Bankr. D. Mass. 1991).

the debtor at the termination of the case.¹⁰⁸ However, taxes placed upon the estate for gains on the abandonment of property most likely would not be given administrative priority. Administrative priority may be given to taxes that are actual and necessary expenses of preserving the estate¹⁰⁹ or taxes incurred by the estate.¹¹⁰ We have already determined that abandonment does not fit within the "incurred by the estate" definition.¹¹¹ Thus, for the tax to be considered an administrative expense, it must constitute an actual and necessary expense of preserving the estate. The phrase, "actual and necessary," must be narrowly construed to meet an overriding concern in the Bankruptcy Code: to keep fees and administrative expenses at a minimum so as to preserve as much of the estate as possible for the creditors.¹¹² The courts have devised a two-part test for determining whether an expense qualifies as an administrative expense: (1) whether the claim arose postpetition, and (2) whether the debt substantially benefited the estate.¹¹³

Clearly, a tax liability arising from an abandonment arises postpetition. The question is whether it substantially benefits the estate. The estate is benefited in that it is relieved of the secured portion of the debt attached to the property. However, it also gives up the encumbered property that would be used to pay that debt. As such, there is no net benefit. There may even be a net loss to the estate if the estate has had to make any mortgage or property tax payments on the property during the period between the commencement of the bankruptcy case and the abandonment of the property.

One may also consider the fact that the estate is relieved of the burden of administering that property. Is this benefit substantial enough to meet the test? When one considers the overriding concern associated with the section granting administrative expenses—to keep administrative fees to a minimum¹¹⁴—it is unlikely that this benefit is sufficient to qualify the tax as an administrative

¹⁰⁸ See *supra* text accompanying note 76.

¹⁰⁹ 11 U.S.C. § 503(b)(1)(A) (1988).

¹¹⁰ *Id.* § 503(b)(1)(B)(i).

¹¹¹ See *supra* notes 92–94 and accompanying text.

¹¹² *E.g.*, *Otte v. United States*, 419 U.S. 43, 53 (1974); *In re N.P. Mining Co.*, 963 F.2d 1449, 1453–54 (11th Cir. 1992); *In re United Trucking Service, Inc.*, 851 F.2d 159, 164 (6th Cir. 1988); *In re Drexel Burnham Lambert Group, Inc.*, 134 B.R. 482, 488 (Bankr. S.D.N.Y. 1991); *In re O.P.M. Leasing Services, Inc.*, 23 B.R. 104, 121 (Bankr. S.D.N.Y. 1982). Courts have noted a competing concern in Chapter 11 cases: allowing essential costs of administering an ongoing business venture to be paid up front to give the debtor its best shot at emerging as a vital concern. *In re Dant & Russell, Inc.*, 853 F.2d 700, 707 (9th Cir. 1988); *In re Baldwin-United Corp.*, 43 B.R. 443, 452 (S.D. Ohio 1984).

¹¹³ *E.g.*, *In re Dant & Russell*, 853 F.2d at 706–07; *Wolf Creek Collieries Co. v. GEX Kentucky, Inc.*, 127 B.R. 374, 379 (N.D. Ohio 1991).

¹¹⁴ See *supra* note 112 and accompanying text.

expense. Because this tax is a post petition debt, it cannot be given priority under section 507(a)(7) of the Bankruptcy Code,¹¹⁵ nor is it even dischargeable under section 727(b).¹¹⁶ Therefore, the tax would pass out of the estate to the debtor upon termination of the estate, thus undermining the overall purpose of the entrapment theory.

2. *The Deflection Theory*

a. *A Look at the Theory Itself*

It has been held for nontax purposes that an abandonment relates back to the date of the filing of the petition in bankruptcy. In other words, title to the property reverts back to the debtor and stands as if no transfer to the estate had been made.¹¹⁷ The deflection theory relies on this premise for the proposition that abandonment also relates back to the date of filing for purposes of taxation.¹¹⁸ Because this theory essentially disregards any transfer made to the estate upon commencement of the case, abandonment of property back to the debtor could not give rise to taxable income to the estate. The Bankruptcy Code does not specify that the abandonment of property is to relate back to the date of the commencement of the case; however, the Code does not expressly preclude such a reading.¹¹⁹

b. *The Case Law Supporting the Deflection Theory*

The deflection theory has its roots in the 1937 Supreme Court decision of *Brown v. O'Keefe*.¹²⁰ In that case, the Court held that even though the debtor filed bankruptcy, he was still the owner of certain shares of stock and, therefore, not relieved of the liabilities attendant upon such ownership.¹²¹ The

¹¹⁵ Section 507 grants a priority only to those taxes that were assessed, or that related to a taxable year ending, *on* or *before* the date of the filing of the bankruptcy petition. 11 U.S.C. § 507(a)(7) (1988).

¹¹⁶ Section 727 grants the debtor a discharge from all debts that arose *before* commencement of the bankruptcy case. *Id.* § 727(b).

¹¹⁷ See *infra* notes 120–28 and accompanying text; see also *Mason v. Commissioner*, 646 F.2d 1309, 1310 (9th Cir. 1980); *In re Nevin*, 135 B.R. 652, 653 (Bankr. D. Haw. 1991); Frankel, *supra* note 34, at 40–41; Nelson, *supra* note 62, at 236–40; Wallace, *supra* note 46, at 26.

¹¹⁸ See Nelson, *supra* note 62, at 236–40.

¹¹⁹ See 11 U.S.C. § 554 (1988).

¹²⁰ 300 U.S. 598 (1937).

¹²¹ *Id.* at 602.

Court reasoned that upon abandonment of the property, title reverts to the debtor as of the date the petition was filed, and it "stands as if no assignment had been made."¹²² Therefore, the debtor was treated as the continuous owner of the stock.

In *In re Cruseturner*,¹²³ the court held that abandonment of property revested title in the debtor so as to become "property of the debtor" and thus subject to the automatic stay protection of section 362(a)(5).¹²⁴ In so holding, the court adopted the precise language written by the *Brown* Court more than 40 years earlier.¹²⁵

*In re Bentley*¹²⁶ appears to have been the only case to apply the deflection theory to a determination of tax liability. In that case, the trustee sold a corn crop free and clear of any liens for cash and held the proceeds subject to a lien in favor of the Commodity Credit Corporation. Three years later, the trustee abandoned the proceeds to the debtor.¹²⁷ The court held that the estate was not liable for the taxes, because the abandonment revested the debtor with all interests to the property. Thus, the estate was never entitled to the proceeds as required by section 1398(e) and, therefore, could not be taxed upon them.¹²⁸

c. Problems Inherent in the Deflection Theory

The appeal of the deflection theory, which relates the date of abandonment back to the date of the filing of the petition in bankruptcy, lies in its simplicity and convenience as a tool to achieve desirable results. However, this is where the theory's usefulness ends. The theory simply has no basis in law.

¹²² *Id.* (citing *Sessions v. Romadka*, 145 U.S. 29, 52 (1892)).

¹²³ 8 B.R. 581 (Bankr. D. Utah 1981).

¹²⁴ *Id.* at 591-92.

¹²⁵ Whatever title or inchoate interest may have passed to the trustee was extinguished by relation as of the filing of the petition when the trustee informed the court that the shares were burdensome assets, and was directed by the court to abandon and disclaim them. In such case "the title stands as if no assignment had been made."

Id. at 591 (citing *Brown v. O'Keefe*, 300 U.S. 598, 602 (1937)).

¹²⁶ 79 B.R. 413 (Bankr. S.D. Iowa 1987), *rev'd*, 89-2 U.S. Tax Cas. (CCH) ¶ 9597 (S.D. Iowa 1988), *aff'd*, 916 F.2d 431 (8th Cir. 1990).

¹²⁷ *Id.* at 414-15.

¹²⁸ *Id.* at 416. This opinion was reversed because the trustee had converted the corn crop to cash and exercised complete dominion and control over the proceeds. Because the trustee had administered this asset, the estate was entitled to the proceeds and, therefore, should bear the tax burden. *In re Bentley*, 89-2 U.S. Tax Cas. (CCH) ¶ 9597. The court specifically noted, however, that had the trustee abandoned the corn crop itself to the debtor, it would have related back, and the tax would have accrued to the debtor. *Id.*

The Bankruptcy Code does not mention relating the time of the abandonment back to the petition's filing date.¹²⁹ Clearly, legal title to the debtor's property passes to the estate when the petition is filed.¹³⁰ It is also clear that legal title passes back to the debtor when the property is abandoned.¹³¹ The deflection theory ignores these transfers, treating them as if they never occurred. The case law supports characterization of this theory as a "legal fiction."¹³²

The theory is especially suspect when one considers that property may be abandoned to any party with a possessory interest.¹³³ If the trustee decided to abandon the property to someone other than the debtor with a possessory interest, then it is very difficult to treat the property as if no bankruptcy has been filed.

D. Convergence of the Two Theories: Cases Adopting a Middle Approach

There are two cases that reject the entrapment theory yet do not quite go so far as to adopt the deflection theory. As such, they are more appropriately dealt with in a separate section.

In *In re McGowan*,¹³⁴ the trustee abandoned certain equipment and machinery to the debtor because there was no equity in the property and it was burdensome to the estate. The trustee then filed an application for determination of tax liability, arguing that the abandonment was a taxable disposition by the estate. Not surprisingly, the debtor agreed with the trustee.¹³⁵

The court held that abandonment of property by the trustee in bankruptcy is not a sale or exchange that triggers tax liability chargeable to the estate.¹³⁶ In

¹²⁹ See 11 U.S.C. § 554 (1988).

¹³⁰ *Id.*

¹³¹ *In re Cruseturner*, 8 B.R. 581, 591 (Bankr. D. Utah 1981); KING, *supra* note 58, ¶ 554.02(2); Nelson, *supra* note 62, at 237.

¹³² *In re Ira Haupt & Co.*, 398 F.2d 607, 613 (2d Cir. 1968); *Wallace v. Lawrence Warehouse Co.*, 338 F.2d 392, 394 n.1 (9th Cir. 1964); *Rosenblum v. Dingfelder*, 111 F.2d 406, 409 (2d Cir. 1940); *Barletta v. Tedeschi*, 121 B.R. 669, 674 (N.D.N.Y. 1990).

¹³³ S. REP. NO. 989, *supra* note 51, at 92, reprinted in 1978 U.S.C.C.A.N. at 5878; H.R. REP. NO. 595, *supra* note 57, at 377, reprinted in 1978 U.S.C.C.A.N. at 6333.

¹³⁴ 95 B.R. 104 (Bankr. N.D. Iowa 1988).

¹³⁵ *Id.* at 105-06. The court expressed concern that in taking this position, the trustee was more concerned with protecting the postbankruptcy debtor than with acting in the best interests of the estate. *Id.*

¹³⁶ *Id.* at 108.

so holding, the court first rejected the debtor's (and the trustee's in this case) argument that section 1398(f)(2) does not apply to abandonments during the bankruptcy case, because they do not occur "at the termination of the estate." The court began its analysis by noting that section 1398(f)(2) does not define the phrase "termination of the estate" and that the phrase is open to several interpretations:

This term *could* mean the closing of a case after full administration of the estate; a termination of the estate's interest in property by virtue of abandonment or exemption; the termination of the estate's interest in property as a result of completed state or federal court proceedings following modification or termination of the automatic stay if such proceedings terminate the estate's interests under state law. It could have other meanings.¹³⁷

The court stated that "§ 1398(f)(2) was not drafted by Congress with an eye to bankruptcy terminology" and concluded that the court must define those words in a bankruptcy context. Then the court, without analysis or reasoning, simply concluded that "the meaning of 'termination of the estate' includes the termination of the estate's interest in property pursuant to 11 U.S.C. §§ [sic] 554(a)." ¹³⁸

The court then rejected the debtor's argument that the estate could not escape tax consequences under section 1398(f)(2), because the abandonment constituted a "sale or exchange" under *Yarbro*.¹³⁹ In *Yarbro*, the Fifth Circuit held that an abandonment of property subject to nonrecourse debt constituted an exchange resulting in capital loss treatment.¹⁴⁰ In finding that the abandonment constituted an exchange, the court stated that:

The term "exchange," in its most common, ordinary meaning implies an act of giving one thing in return for another thing regarded as an equivalent. . . . Thus, three things are required: a giving, a receipt, and a causal connection between the two. In the case of abandonment of property subject to nonrecourse debt, the owner gives up legal title to the property. The mortgagee, who has a legal interest in the property, is the beneficiary of this gift, because the mortgagee's interest is no longer subject to the abandoning owner's rights.¹⁴¹

¹³⁷ *Id.* at 107.

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Yarbro v. Commissioner*, 737 F.2d 479, 485-86 (5th Cir. 1984), *cert. denied*, 469 U.S. 1189 (1985).

¹⁴¹ *Id.* at 483-84.

The *Yarbro* court also noted that the taxpayer who abandoned the property received a benefit in the form of relief from the obligation to pay the debt and the taxes and assessments against the property, even though the debt was nonrecourse.¹⁴²

The *McGowan* court, however, refused to apply the *Yarbro* analysis to abandonments of property during bankruptcy. The court noted that although the trustee divests the estate of legal title to the property upon abandonment, the trustee receives only relief from the obligation to administer the property. The court did not consider this relief the kind of benefit necessary to constitute an "exchange."¹⁴³

In a very similar case before the same court, the court refused to overrule *In re McGowan*.¹⁴⁴ In *In re Olson*, the trustee abandoned to the debtors certain tracts of land subject to mortgages. The foreclosure proceedings, which had commenced before bankruptcy, had been stayed upon the filing of the bankruptcy petition.¹⁴⁵ The trustee failed to file income tax returns for the estate, and the debtors prepared returns reporting the gain on the abandonment. The trustee sought a determination from the court that the estate was not liable for the taxes arising from the abandonment.¹⁴⁶

The court relied on *In re McGowan* in holding that the abandonment did not constitute a sale or exchange that would trigger tax liability chargeable to the estate. The court first rejected the debtors' argument that the abandonment constituted an exchange under *Yarbro*.¹⁴⁷ The *Olson* court, however, went one step further than the *McGowan* decision. Not only did the trustee not receive the sort of benefit necessary for an "exchange," but he also did not give anything, because he could not transfer title.¹⁴⁸

¹⁴² *Id.* at 484 (citing *Crane v. Commissioner*, 331 U.S. 1 (1947)).

¹⁴³ *In re McGowan*, 95 B.R. at 108.

¹⁴⁴ *In re Olson*, 100 B.R. 458 (Bankr. N.D. Iowa 1989), *aff'd*, 121 B.R. 346 (N.D. Iowa 1990), *aff'd*, 930 F.2d 6 (8th Cir. 1991). Other courts have adopted the reasoning of the *McGowan* and *Olson* courts. *In re Terjen*, 154 B.R. 456 (E.D. Va. 1993); *In re Burpo*, 148 B.R. 918 (Bankr. W.D. Mo. 1993); *In re Nevin*, 135 B.R. 652 (Bankr. D. Haw. 1991); *see also* Lipton, *supra* note 13, at 14; Madoff, *supra* note 95, at 789-91. The Internal Revenue Service, too, has adopted the conclusion reached in *In re McGowan* and *In re Olson*. Prop. Treas. Reg. §§ 1.1398-1(d)(1), -2(d)(1); Priv. Ltr. Rul. 90-17-075 (Apr. 27, 1990).

¹⁴⁵ *See supra* note 9 and accompanying text.

¹⁴⁶ *In re Olson*, 100 B.R. at 460.

¹⁴⁷ *Id.* at 462-63.

¹⁴⁸ *Id.* at 463. In *In re McGowan*, the court recognized the fact that the trustee divested the estate of title to the property as sufficient to support a "giving" by the trustee. *In re McGowan*, 95 B.R. 104, 108 (Bankr. N.D. Iowa 1988). Upon commencement of a

The court then rejected the debtors' second argument that the abandonment did not result from the "termination of the estate." The court recognized that the *McGowan* decision may have been overbroad in defining "termination of the estate" and acknowledged that a better definition might be "the closing of the case."¹⁴⁹ Even adopting this definition of "termination of the estate," the court still held that abandonment would not give rise to a taxable gain. The court could see no reason why abandonment during the administration should have a different tax effect than abandonment by operation of law as a result of property being unadministered at the close of the case.¹⁵⁰

Finally, the court rejected the debtors' argument that shifting the burden of taxes to the debtor is improper, because it burdens the fresh start policy of the Bankruptcy Code. The court reasoned that the Chapter 7 debtor is not given a fresh start from all debts and held that any such concern about damage to the debtor's fresh start must be addressed by Congress.¹⁵¹

IV. THE PROPER TAX TREATMENT OF ABANDONMENTS

Neither the entrapment nor the deflection theory withstands close scrutiny. A middle approach such as that adopted in *In re McGowan* and *In re Olson* should be applied. That is, abandonment by a trustee in bankruptcy should not be considered a sale or exchange giving rise to a taxable gain to the estate as it is under the entrapment theory. Nor should the existence of the estate be ignored by relating the date of abandonment back to the filing of the bankruptcy petition as it is under the deflection theory. However, the reasoning of the *McGowan* and *Olson* courts must not be blindly followed. Although their conclusions are correct, their reasoning is incomplete and somewhat flawed.

First, the *McGowan* court's definition of "termination of the estate" as including the termination of the estate's interest in property by abandonment¹⁵² was supported by no analysis or reasoning. The court apparently realized its error in *In re Olson* and acknowledged that a better definition might be "the

case in bankruptcy, the debtor transfers title in the property to the estate—not the trustee. See 11 U.S.C. § 541(a) (1988).

¹⁴⁹ *In re Olson*, 100 B.R. at 463.

¹⁵⁰ *Id.* 11 U.S.C. § 554(c) provides that property unadministered at the close of the case is abandoned to the debtor by operation of law. I.R.C. § 1398(f)(2) provides tax-free treatment for any transfer of property from the estate to the debtor at the termination of the estate. It does not exclude transfers by operation of law.

¹⁵¹ *In re Olson*, 100 B.R. at 464.

¹⁵² *In re McGowan*, 95 B.R. at 107.

closing of the case.”¹⁵³ This definition is much more in line with the traditional definition of “termination.”¹⁵⁴ The *Olson* court went on to conclude that even though abandonment did not constitute a “termination of the estate” by definition, the court could see no reason for treating it differently than abandonment by operation of the law as a result of property being unadministered at the close of the case.¹⁵⁵ But the court stopped its discussion there, offering no reason for its conclusion.

Certainly, there is no substantive difference between abandonment during bankruptcy and abandonment by operation of law at the close of the case under section 554(c) of the Bankruptcy Code. In both situations, there is no administering of the property by the trustee.¹⁵⁶ Furthermore, if abandonment during bankruptcy were to give rise to taxable income to the estate, the trustee could simply hold onto the property without administering it until the close of the bankruptcy case, when the property would revert tax free back to the debtor.¹⁵⁷ This result would effectively write section 554(a), which gives the trustee the power to abandon property, out of the Bankruptcy Code—a result that most likely was not intended by Congress.

Moreover, the Bankruptcy Code provides that for state income tax purposes, “neither gain nor loss shall be recognized on a transfer . . . other than a sale, of property from the estate to the debtor”¹⁵⁸ Thus, an abandonment of property by a trustee—regardless of whether it occurs in connection with the termination of the estate—does not trigger gain or loss to the estate for state income tax purposes, unless the transfer constitutes a true sale. There is no apparent reason why abandonment of property should have different consequences for state income tax purposes than for federal income tax purposes.¹⁵⁹

Second, both the *McGowan* and the *Olson* courts specifically declined to apply the *Yarbro* analysis to abandonments of property during bankruptcy. The courts held that although the trustee receives relief from the obligation to

¹⁵³ *In re Olson*, 100 B.R. at 463.

¹⁵⁴ Termination is defined as an “[e]nd in time or existence; close; cessation; conclusion.” BLACK’S LAW DICTIONARY 1471 (6th ed. 1990).

¹⁵⁵ *In re Olson*, 100 B.R. at 463; see 11 U.S.C. § 554(c) (1988).

¹⁵⁶ See *supra* note 94 and accompanying text.

¹⁵⁷ This argument assumes that the court has not ordered the trustee to abandon the property. 11 U.S.C. § 554(b) (1988).

¹⁵⁸ *Id.* § 346(g)(1)(B).

¹⁵⁹ Wallace, *supra* note 46, at 27. But see Lipton, *supra* note 13, at 14; Madoff, *supra* note 95, at 78 (both noting that the plain language of I.R.C. § 1398(f)(2) provides for nonrecognition of gain or loss *only* in the case of a “termination of the estate,” which does not include abandonment).

administer the property, that kind of benefit is not the kind of benefit necessary to an exchange.¹⁶⁰ The *Olson* court went even further and held that the other major requirement for an exchange, the giving, was also absent, because the trustee could not transfer a title that never vested in him.¹⁶¹

In arriving at this conclusion, the *McGowan* and *Olson* courts focused on the trustee as the exchanging party instead of the estate. However, upon commencement of the bankruptcy case, title to the debtor's property vests in the estate—not in the trustee.¹⁶² In addition, the estate—not the trustee—bears the burden of any tax imposed on the estate.¹⁶³ Therefore, it is only logical to analyze the exchange from the estate's point of view. Instead of twisting the analysis to take the abandonment out of the scope of *Yarbro*, the *McGowan* and *Olson* courts should have held that the *Yarbro* analysis simply does not apply in a bankruptcy context. In order for a bankruptcy estate to recognize income, it must be entitled to it.¹⁶⁴ A bankruptcy estate does not become entitled to income through mere abandonment of property.¹⁶⁵

In short, the *McGowan* and *Olson* courts arrived at the proper conclusions, but the reasoning behind these conclusions must be clarified before using them as the standard governing the taxation of abandonments in bankruptcy.

Because the Bankruptcy Tax Act does not expressly deal with the tax treatment of abandonments,¹⁶⁶ some other law must apply. The entrapment theory mandates that general tax law apply. However, because we are dealing with a bankruptcy situation, general tax law must be reconciled with bankruptcy law in determining whether abandonment is a taxable event. Bankruptcy is a unique situation, which creates two separate taxpayers. As such, a determination must be made as to which taxpayer is entitled to the income from the gain on the property. As was previously determined, the estate is entitled to gross income when the trustee administers the estate. Yet the trustee is not administering anything by simply abandoning property.¹⁶⁷ Therefore, abandonment cannot give rise to income taxable to the estate.

In addition, consideration must be given to the purposes underlying the Internal Revenue Code and the Bankruptcy Code. As noted above, our tax

¹⁶⁰ *In re Olson*, 100 B.R. 458, 462–63 (Bankr. N.D. Iowa 1989), *aff'd*, 121 B.R. 346 (N.D. Iowa 1990), *aff'd*, 930 F.2d 6 (8th Cir. 1991); *In re McGowan*, 95 B.R. 104, 108 (Bankr. N.D. Iowa 1988).

¹⁶¹ *In re Olson*, 100 B.R. at 463.

¹⁶² See 11 U.S.C. § 541(a) (1988); *In re Robison*, 74 B.R. 646, 647 (E.D. Mo. 1987).

¹⁶³ See *supra* note 46.

¹⁶⁴ I.R.C. § 1398(e)(1) (1988).

¹⁶⁵ See *supra* notes 89–94 and accompanying text.

¹⁶⁶ See I.R.C. § 1398(f)(1)–(2) (1988).

¹⁶⁷ See *supra* notes 91–94 and accompanying text.

system, based primarily on voluntary assessments, works only to the extent that taxpayers think it is fair. The overall fairness must not be jeopardized by permitting taxpayers to use bankruptcy as a means for improperly avoiding their tax debts.¹⁶⁸ If the tax debt properly belongs to the debtor, the debtor must not be allowed to force the creditors to bear the burden of that tax debt. In addition, the Internal Revenue Code generally attempts to postpone taxation until final disposition of the property.¹⁶⁹ Such postponement avoids uncertainty in the tax law and the administrative burden of determining whether a particular event is taxable on a case-by-case basis.

These purposes must be reconciled with those underlying the Bankruptcy Code. It is often said that the primary purpose of the Bankruptcy Code is to provide the debtor a fresh start.¹⁷⁰ However, the provision allowing for abandonment is not intended to benefit the debtor, but rather is intended to provide for the orderly and efficient reduction of the bankrupt's debts.¹⁷¹ In addition, the fresh start policy is not without its limitations. The Chapter 7 debtor is not given a fresh start from all debts.¹⁷² Furthermore, upon abandonment, the automatic stay is still effective.¹⁷³ Thus, the debtor still has time to try to work something out with the creditors in order to attempt to preserve the debtor's fresh start.¹⁷⁴ Also, unless the stay is lifted by the court, it will continue in effect until the earliest of the closing of the case, dismissal, or the granting of a discharge.¹⁷⁵ Thus, by the time foreclosure is permitted, the debtor will have regained possession of the tax attributes.¹⁷⁶ Even if the court lifts the automatic stay, the proposed regulations to section 1398 provide for the return of two tax attributes—passive activity losses and losses suspended under the at-risk rules of section 465—to the debtor upon abandonment of property by a trustee.¹⁷⁷

Keeping these purposes in mind, it seems proper and fair to conclude that an abandonment is not taxable to the estate, but rather is taxable to the debtor upon subsequent disposition of the property.

¹⁶⁸ See *supra* note 55 and accompanying text.

¹⁶⁹ See *supra* notes 104–07 and accompanying text.

¹⁷⁰ See *supra* note 51 and accompanying text.

¹⁷¹ See *supra* note 58 and accompanying text.

¹⁷² 11 U.S.C. §§ 523, 727 (1988); see also *In re Olson*, 100 B.R. 458, 464 (Bankr. N.D. Iowa 1989), *aff'd*, 121 B.R. 346 (N.D. Iowa 1990), *aff'd*, 930 F.2d 6 (8th Cir. 1991).

¹⁷³ 11 U.S.C. § 362(a)(5) (1988); see also *In re Shields*, 24 B.R. 219, 220 (Bankr. S.D. Ohio 1982); *In re Bennett*, 13 B.R. 643, 645 (Bankr. W.D. Mich. 1981).

¹⁷⁴ See, e.g., 11 U.S.C. §§ 524(e) (reaffirmation), 722 (redemption) (1988).

¹⁷⁵ *Id.* § 362(c)(2).

¹⁷⁶ I.R.C. § 1398(i) (1988).

¹⁷⁷ Prop. Treas. Reg. §§ 1.1398-1(d)(2)(ii), -2(d)(2), Fed Reg. 53300-02 (1992).

V. TAX PLANNING STRATEGIES FOR THE DEBTOR

If the conclusion of this Comment is followed, and an abandonment by a trustee in bankruptcy is taxable to the debtor upon subsequent disposition and not to the estate, there are certain strategies that a debtor can employ to mitigate this tax liability.

First, before filing bankruptcy, a debtor may sell, or encourage the creditors to foreclose upon, any property that is fully encumbered and thus likely to be abandoned by the trustee in bankruptcy. However, this tax will not accrue until the end of the calendar year; thus, the tax will be considered a post petition debt, which is not payable out of the estate. A debtor may, however, elect to truncate the taxable year on the date of the filing of the bankruptcy petition.¹⁷⁸ This truncation, in effect, creates two short taxable years, and any tax liabilities incurred in the first short year become prepetition debts. These liabilities are transferred to the estate upon commencement of the bankruptcy case,¹⁷⁹ and the tax claim would be entitled to a priority payment from the funds of the estate.¹⁸⁰ While such a debt is nondischargeable if the assets of the estate are insufficient to pay it,¹⁸¹ the debtor's chance of avoiding personal liability for the tax debt is much greater.

Second, as an alternative to shifting the tax liability to the estate, a debtor may sell any nonexempt assets before filing for bankruptcy, then deposit the money received with the Internal Revenue Service to cover the estimated tax payments that would arise upon subsequent disposition of the abandoned asset by the debtor.¹⁸²

¹⁷⁸ I.R.C. § 1398(d)(2); see, e.g., David F.P. O'Connor, *When the Workout Fails: Abandonment, Repossession, Foreclosures, and Procedural Considerations*, in *TAX ASPECTS OF WORKOUTS, INSOLVENCY, AND BANKRUPTCY 1991*, at 229 (ALI-ABA Course of Study Series No. c701, 1991); Onsager, *supra* note 12, at 105-06; Ritt & Burke, *supra* note 34, at 186.

¹⁷⁹ 11 U.S.C. § 541(a) (1988).

¹⁸⁰ Specifically, this tax claim is entitled to the seventh highest priority. *Id.* § 507(a)(7).

¹⁸¹ *Id.* § 523(a)(1); see also S. REP. NO. 1035, *supra* note 22, at 24, reprinted in 1980 U.S.C.C.A.N. 7017, 7039; H.R. REP. NO. 833, *supra* note 22, at 19.

¹⁸² This strategy has been upheld by at least one bankruptcy court. *In re Halle*, 132 B.R. 186 (Bankr. D. Colo. 1991) (holding that estimated taxes paid by a debtor prepetition and applied to the debtor's tax liability were not property of the debtor's bankruptcy estate and thus could be used by the debtor and not the estate).

VI. CONCLUSION

It would have been a simple task for Congress to have included a provision in the Bankruptcy Tax Act of 1980¹⁸³ that governed the tax treatment of abandonments in bankruptcy. However, Congress, either purposely or inadvertently, left this issue to judicial interpretation. The courts have not fared better in resolving the issue. Two theories have emerged, mandating completely opposite conclusions.

This Comment has analyzed the two theories and has concluded that both theories are seriously flawed. The Bankruptcy Court for the Northern District of Iowa, in two different cases, has adopted a middle approach. The court concluded that an abandonment by a trustee in bankruptcy does not constitute a "sale or exchange" that would give rise to a taxable gain to the estate (*i.e.*, it rejected the entrapment theory). The court did not quite conclude, however, that for tax purposes, title to the abandoned property reverts back to the debtor, standing as if no transfer to the estate had occurred (*i.e.*, it did not adopt the deflection theory). This conclusion is correct, although the court's reasoning is rather incomplete.

This Comment has attempted to fill the gaps in the *McGowan* and *Olson* court's reasoning and further support the court's reasoning by reconciling the purposes behind the Internal Revenue Code and the Bankruptcy Code.

Lisa M. Hebenstreit

¹⁸³ I.R.C. §§ 1398-1399 (1988).

