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The Tax Consequences of Abandonment under the Bankruptcy Code

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A foreclosure can often be a tax disaster. If the property has been heavily depreciated, and so has a low basis, a sale or disposition of that property at a price in excess of the tax basis will result in the realization of income. Who must pay the tax on the realized income is often a bone of contention.

If a debtor has filed a bankruptcy petition, and the bankruptcy estate permits a foreclosure of property at a price in excess of the tax basis, then the bankruptcy estate will be responsible for paying the tax. However, if the property is abandoned by the bankruptcy estate before foreclosure, then the debtor must realize the income and pay the tax. This can count as a heavy blow to an individual debtor who thought he or she was obtaining a "fresh start" after receiving a discharge of debts in bankruptcy. Frequently, any gain from the foreclosure is purely a gain on paper and does not result in the payment of any cash to a debtor, even though the debtor remains responsible for the payment of the tax.

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This article analyzes the abandonment issue in the bankruptcy context and highlights the difficulties encountered by courts attempting to determine who is ultimately responsible for the taxes generated by postpetition foreclosures. This article also identifies the strengths and weaknesses of the competing paradigmatic models and proposals to account for the conflicting interests and policy rationales inherent in the bankruptcy abandonment of low-basis property. After this review, this article proposes a model that is based on an ability-to-pay norm and that accommodates the conflicting interests presented.

To an individual debtor contemplating relief under the Bankruptcy Code ("BC"),[1] nothing appears as precious as the right to a discharge. Along with exemptions provided to an individual debtor under BC section 522 and a carve-out of future income earned by a debtor from the bankruptcy estate under BC section 541(a)(6),[2] the right to a discharge ensures that an honest but unfortunate debtor has a fresh start to begin anew his or her economic life.

Recognizing that nondischargeable tax liabilities[3] are inconsistent with the fresh start policy, Congress attempted to alleviate some harshness by enacting the Bankruptcy Tax Act of 1980 ("BTA"). Among other things, the BTA creates a separate taxable entity when an individual files for relief under chapter 7 or 11 of the BC[4] and enables an individual chapter 7 or 11 debtor to elect to shorten and end the taxable year, thus shifting at least part of the current year's taxes to the estate as a BC section 507(a)(7) priority claim.[5] Nevertheless, certain tax claims designated as nondischargeable under BC section 523(a)(1) (such as claims for taxes for taxable years generally ending within three years of commencement of the bankruptcy case) survive the discharge and, thus, significantly affect a debtor's fresh start.

Nothing captures the attention of a bankruptcy trustee, a debtor, the creditors, and the Internal Revenue Service ("Service") like the issues posed by the bankruptcy estate's abandonment of property subject to a mortgage greater than the adjusted basis in the property.[6] Some of these issues include

1. References to the Bankruptcy Code are to Title 11, United States Code.

2. Generally, property of the estate under the BC includes all of a debtor's legal or equitable interest in property wherever located and by whomever held. 11 U.S.C. § 541(a)(1)-(7) (1988). Nonetheless, § 541(a)(6) provides that "earnings from services performed by an individual debtor after the commencement of the case" are not property of the estate. 11 U.S.C. § 541(a)(6).

3. *See* 11 U.S.C. § 523(a)(1) (1988) (identifying those tax claims that are nondischargeable by individual debtor in chapter 7 or 11 case, including priority tax claims).

4. I.R.C. § 1398 (1988).

5. *Id.* § 1398(d)(2).

6. The basis of an asset is generally its historic cost. I.R.C. § 1012 (1988). Essentially, the function of basis in the context of realization of gain or loss is to prevent the same dollars from being taxed twice. *See* JOSEPH M. DODGE, THE LOGIC OF TAX 6 (1989). Adjusted basis is the historic cost increased by capital expenditures such as improvements to the asset and decreased by allowed depreciation. *Id.*

who must pay the tax, whether the tax claim is entitled to priority status, and whether any claim is dischargeable.

Part I analyzes an individual debtor's right to a discharge in chapter 7 and 11 cases. The statutory scheme behind the right to discharge embodied in the BC is explored with an eye toward providing context to the debate. In particular, the discussion shows that the right to a discharge is not absolute and is not without limitation. Part II analyzes the separate entity rules embodied in Internal Revenue Code ("IRC") section 1398. Unlike any other debtor under the BC, an individual chapter 7 or 11 debtor may take advantage of a powerful tax reduction tool. For example, IRC section 1398 treats the bankruptcy estate as a separate taxable entity that computes and pays its own taxes separate from the individual debtor. Through careful planning, a debtor may employ IRC section 1398 to shift at least some of his or her tax liability for current year's taxes to the estate. Without IRC section 1398, the filing of the bankruptcy petition would have no tax significance, and current year's taxes would generally be nondischargeable. Part III explores a trustee's ability to abandon property under BC section 554. The history, power, and limitations of abandonment are carefully scrutinized to comprehend exactly what is happening, in a legal sense, to property that is abandoned pursuant to the BC. This article concludes that by abandoning estate property, a trustee is disclaiming his or her interest in the form of a judicial lien in the abandoned property. The article rejects the traditional concepts of relation back as confusing and unnecessary fictions. Part IV highlights the attendant risks in the debate over the tax consequences of bankruptcy abandonment by presenting an example and then applying and critiquing the arguments for and against taxable abandonment. I believe the issue is much closer than many suspect. Although I cannot easily dispatch the arguments supporting taxable abandonment, the better view is that abandonment under BC section 554 is not a taxable event. Part IV also rejects the paradigmatic models of abandonment and opts for a more robust and comprehensive model which addresses the issues posed by the tax consequences of abandonment under the BC, and suggests modification of BC section 554 and IRC sections 108 and 1398.

I. The Right to Discharge

In filing for relief under the BC, an individual's most important objective is a discharge from his or her debts.[7] The discharge is the heart of the fresh start policy promoted by the BC. The chapter 7 discharge is granted virtually automatically unless an objecting party can establish that the debtor has engaged in prohibited conduct. This prohibited conduct usually constitutes some type of fraud or bankruptcy crime.[8] The statute providing for discharge

7. *See generally* Douglas G. Baird, The Elements of Bankruptcy 27-44 (1992) (discussing fresh start policy); David G. Epstein et al., 2 Bankruptcy § 7-16 (1993) (same).

8. 11 U.S.C. § 727(a) (1988).

is liberally construed in favor of an individual debtor.[9] Thus, the objecting party has the burden of establishing a ground for the denial of a discharge.[10]

Although understood as part of the warp and woof of bankruptcy law, the right to discharge was not part of the early enactments of bankruptcy acts in the United States.[11] In fact, it was not until the enactment of the Bankruptcy Act of 1898 that the law provided an individual debtor with a right to discharge certain debts pursuant to the bankruptcy process. Moreover, contrary to conventional wisdom, there is no constitutional right to a discharge; discharge is a statutory privilege provided to the honest but unfortunate debtor[12] who has not abused the bankruptcy process.[13]

A discharge in a bankruptcy case voids any judgment to the extent that it is a determination of the debtor's personal liability with respect to a prepetition debt.[14] The discharge also operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, including telephone calls, letters, and personal contact, to collect, recover, or offset any discharged debt.[15] In effect, the discharge is a total prohibition on debt collection efforts against a debtor. Furthermore, under BC section 524, any attempt to reaffirm a discharged debt is void unless the provisions of the BC delineating the requirements of reaffirmation are specifically followed.[16]

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

10. If a debtor has been denied a discharge in a bankruptcy case, so that all his or her debts remain outstanding, the debtor may not include the same obligations in a subsequent case to obtain a discharge. The denial of the discharge is *res judicata* as to the obligations existing at that time, which are forever nondischargeable.

11. The Supreme Court noted the comparative newness of the discharge and fresh start policy in bankruptcy in United States v. Kras, 409 U.S. 434, 446-47 (1973).

12. This phrase, first used in Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934), has become a fixture in bankruptcy law.

13. *In re* Wheeler, 101 B.R. 39 (Bankr. N.D. Ohio 1988).

14. 11 U.S.C. § 524(a) (1988).

15. *Id.*

16. *Id.* § 524(c). To ensure the effectiveness of the discharge, 11 U.S.C. § 525(a) prohibits a governmental unit from denying, suspending, or refusing to renew a license or permit or deny employment solely because the person involved was discharged under the BC, was insolvent before the bankruptcy case, or has not paid a dischargeable debt. 11 U.S.C. § 525(a) (1988). Additionally, under § 525(b), no private employer may terminate the employment of, or discriminate with respect to employment against, an individual who is or has been a debtor under the BC, or an individual associated with a debtor under the BC, solely because the debtor is or has been a debtor under the BC, was insolvent before the commencement of a case under the BC, or has not paid a debt that is dischargeable under the BC. *Id.* § 525(b). *See generally* EPSTEIN, *supra* note 7, § 7-40 (noting § 525(b) only applies to "governmental units," which are limited by those prohititions specifically mentioned in this section).

Under BC section 727(a), the bankruptcy court must grant an individual debtor a discharge of prepetition debts unless one of ten conditions is met.[17] Only an individual is eligible for a discharge under chapter 7 pursuant to section 727(a); a partnership or corporation, although legitimate debtors under chapter 7, may not receive a discharge.[18] Additionally, section 727(a) applies only in liquidation cases under chapter 7.[19]

Under chapter 11, BC section 1141(d) governs the scope and limits of a discharge. Pursuant to BC section 1141(d), the confirmation of a plan of reorganization discharges a debtor from any debt that arose before the confirmation of the plan.[20] Unlike section 727(a), a partnership or corporation (as well as an individual) may receive a section 1141(d) discharge. The section 1141(d) discharge is broader than the section 727(a) discharge in that the latter discharges any debts that *arose*[21] before the *order for relief*,[22] while the former discharges any debts that arose before the *confirmation of the plan*.[23]

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17. 11 U.S.C. § 727(a) (1988). Not all debtors are entitled to a discharge under BC § 727(a). *Id.* The right to discharge is a right reserved for the honest but unfortunate debtor. *Id.* Over-extending oneself, unforeseen contingencies, the inability to pay debts, or lack of business acumen are not reasons to deny a debtor's discharge. Fraud, criminal activity, and misconduct, however, are sufficient reasons to deny discharge. *Id.* § 727(a)(2)-(4) & (d)(1). If a creditor or the trustee is successful in attacking the debtor's discharge under § 727(a), then *all claims* survive the bankruptcy case and may be enforced and ultimately satisfied. Grounds for denial of a discharge include: (1) the debtor is not an individual; (2) a transfer or concealment of property within one year of bankruptcy by the debtor with the intent to hinder, delay, or defraud its creditors; (3) the debtor's failure to keep adequate financial records; (4) debtor misconduct during the bankruptcy case, including perjury, false statements, false oaths, or failure to obey a court order; (5) the debtor's inability to explain satisfactorily any losses or deficiencies of assets; and (6) a chapter 7 discharge within six years of the commencement of the pending case. 11 U.S.C. § 727(a)(1)-(5), (8). To object to a debtor's discharge under § 727(a), the creditor must commence an adversary proceeding. FED. R. BANKR. P. 7003. An adversary proceeding is commenced by the filing of a complaint and the issuance of a summons. *Id.* 7004(a). Both the summons and complaint are served on the debtor and the debtor's counsel in accordance with the Federal Rules of Civil Procedure as incorporated by Part 7 of the Bankruptcy Rules. *Id.* 7004(a) & 7004(b)(9). The litigation itself, including discovery, motions for summary judgment, and trial procedures, are governed by Part 7 of the Bankruptcy Rules, which most often incorporate the equivalent Federal Rules of Civil Procedure. Because the BC presumes the debtor is entitled to a discharge, the creditor objecting to the discharge shoulders the burden of proof. *Id.* 4005. Section 727(d) requires the court to revoke a discharge already granted in certain circumstances. 11 U.S.C. § 727(d). If the debtor obtains a discharge through fraud, if he or she acquired and concealed property of the estate, or if he or she refused to obey a court order to testify, the discharge must be revoked. *Id.* Section 727(e) also permits the trustee, a creditor, or the United States trustee to request revocation of a discharge within one year after the discharge is granted for fraud. *Id.* § 727(e).

18. 11 U.S.C. § 727(a)(1).

19. *Id.* § 103(b) (1988).

20. 11 U.S.C. § 1141(d)(1) (1988).

21. It should come as no surprise that just when a debt *arises* has become a bone of contention. EPSTEIN, *supra* note 7, § 7-16.

22. The order for relief is entered automatically when a debtor files a voluntary petition in bankruptcy. 11 U.S.C. § 301 (1988). In an involuntary case, the order for relief comes after the court is persuaded that the grounds for involuntary relief are met. *Id.* § 303(h) (1988).

23. *See id.* § 1129 (1988) (setting forth the requirements for chapter 11 plan confirmation).

Nevertheless, there are limits to the section 1141(d) discharge. First, debts excepted from discharge under section 523 are not discharged under section 1141(d) where the debtor is an individual.[24] Second, if the plan provides for liquidation of all or substantially all of the property of the estate, the debtor does not continue in business, and the debtor would be denied a discharge under section 727(a), then confirmation of the plan does not result in a discharge to the debtor.[25] These limitations are necessary so that an individual debtor may not employ a chapter 11 liquidation plan to evade the exceptions or objections to discharge embodied in BC sections 523(a) and 727(a).[26]

Section 524(d) of the BC requires an individual debtor to appear before the court to receive the discharge if the court decides to conduct a discharge hearing. At the discharge hearing, a court explains to the debtor the nature of the discharge and warns the debtor against reaffirming discharged obligations. The discharge hearing is supposed to be a formal affair that impresses upon an individual debtor the significance of the bankruptcy case.[27] At the discharge hearing, the court will also hear a debtor's attempt to reaffirm any debts.[28]

Despite a debtor's discharge under the BC, certain debts are excepted from discharge as a matter of public policy pursuant to section 523(a).[29]

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24. 11 U.S.C. § 1141(d)(2) (1988).

25. *Id.* § 1141(d)(3) (1988).

26. Chapter 11 recognizes liquidation as an acceptable form of reorganization. *See id.* § 1129(a)(11) (providing that bankruptcy court shall only confirm reorganization plan if it is unlikely that such confirmation will be followed by liquidation or further financial reorganization, unless otherwise provided for in plan); *see also In re* Sandy Ridge Dev. Corp., 881 F.2d 1346 (5th Cir. 1989) (upholding confirmability of liquidation plans).

27. One of the results from the vast increase in bankruptcy filings is the loss of formality in bankruptcy proceedings such as discharge hearings. Although intended as formal affairs, in practice they look more like cattle calls.

28. 11 U.S.C. § 524(d) (1988). Simply, a reaffirmation agreement is an agreement between the debtor and one of the creditors wherein the debtor agrees to pay an otherwise dischargeable debt. As a general rule, reaffirmation agreements are void. However, the BC recognizes certain reaffirmation agreements if certain BC requirements are met. *Id.* § 524(c)(1)-(6) (1988). It is difficult to persuade a court to approve reaffirmation agreements. Courts are particularly careful not to allow the debtor, through good intentions, to throttle the fresh start provided by the BC with otherwise dischargeable debts. This is true because courts recognize that reaffirmations hinder and may even obliterate the debtor's discharge and fresh start. *See generally* EPSTEIN, *supra* note 7, § 7-35 (holding court may approve reaffirmation agreement only after conducting elaborate judicial findings regarding debtor's interest and undue hardship).

29. The following debts are excepted from discharge under BC § 523(a): (1) taxes entitled to priority under BC § 507(a)(2) or (a)(7); (2) taxes connected with fraudulent returns, late returns, or a failure to file; (3) debts incurred by fraud or false financial statements; (4) debts that are not scheduled in time for the timely filing of the proof of claim; (5) debts arising from fraud or defalcation while acting in a fiduciary capacity; (6) debts arising from embezzlement or larceny; (7) alimony, separate maintenance, or child support (but not a property settlement); (8) claims resulting from willful and malicious injury to a creditor or a creditor's property; (9) debts arising from death or personal injury caused by a debtor driving under the influence of drugs or alcohol; (10) debts not discharged in a prior bankruptcy; (11) student loans provided the nondischargeability of debt will not impose an *undue hardship* on the debtor and his dependents;

These exceptions to discharge are strictly construed.[30] The burden of proof to establish that a debt is nondischargeable under section 523(a) falls on the creditor asserting the exception. Among the types of claims that are nondischargeable are current year's taxes and taxes for which the due date falls within three years of the filing of the bankruptcy petition.[31]

II. The Separate Entity Rules

Upon filing a petition for relief under the BC, an estate is created.[32] Under BC section 541(a), property of the estate includes all of a debtor's legal or equitable interest in property at the time of the filing of the petition wherever located and by whomever held. Property subject to exemption under section 522 is included in the definition of property of the estate until it is set aside as provided in section 522.[33] Moreover, all the interest of a

(12) governmental fines and penalties to the extent that they are not compensation for actual pecuniary loss (not including tax penalties relating to dischargeable taxes or to any transaction or event that occurred more than three years before the filing of the bankruptcy petition); and (13) certain claims owed to federally insured financial institutions that have failed or debts owed to a federal depository institutions regulatory agency. 11 U.S.C. § 523(a) (1988).

30. An *exception* to discharge should be contrasted with an *objection* to discharge. If successful in an objection to discharge proceeding, the creditor's claim along with every other claim survives the bankruptcy case; that is, the debtor will not receive a discharge at all. It is significantly different with an exception to discharge proceeding under § 523(a). If successful in asserting § 523(a), the creditor's claim will not be discharged and will survive the bankruptcy case; that is, a § 523(a) claim may be enforced and ultimately satisfied even after the bankruptcy case. 11 U.S.C. § 523(a). Thus, although the debtor receives a general discharge, the § 523(a) claims live on. EPSTEIN, *supra* note 7, § 7-17, at 313.

31. 11 U.S.C. §§ 523(a)(1), 507(a) (1990).

32. *See generally id.* § 541(a)(1)-(7) (1988) (providing that commencement of case pursuant to BC §§ 301-303 creates estate and describing contents of such estate).

33. *Id.* § 522(d) (1990). Section 522(d) provides a complete list of federal exemptions that a debtor may choose if the debtor does not wish to select the exemptions provided by state law. *Id.* § 522(d). Although most states require their debtors to select state exemptions only and forego the federal list by opting out through § 522(b) (for example, Georgia), some states like Texas provide that a debtor may select either the federal list or the state list of exemptions. The federal exemptions include the following: (1) an equity of up to $7,500 in real property or personal property that the debtor or a dependent of the debtor uses as a residence (as compared to the unlimited value homestead exemption under Texas and Florida law); (2) an equity of up to $1,200 in one motor vehicle; (3) household furnishings, household goods, and personal apparel not to exceed $200 in value in any particular item or $4,000 in aggregate value; (4) jewelry not to exceed $500; (5) property, not to exceed in value $400 plus up to $3,750 of any unused amount of the exemption provided in bullet one above (i.e., the federal homestead provision); (6) books and tools of the trade not to exceed $750; (7) life insurance; (8) alimony and child support; (9) special assistance benefits; (10) certain rights in pension or profit sharing plans; and (11) awards from personal injury causes of action or criminal restitution. *Id.* § 522(d)(1)-(11).

As one may observe, the fifth point above is a residual exemption. It permits a debtor to apply any part of the residence exemption that is not used up to $3,750 plus an additional $400 to exempt any type of property, including cash. *Id.* § 522(d)(5). This may be beneficial to an individual debtor who owns no home but has some cash in a bank account.

Bankruptcy Rule 4003 requires a debtor to list and file with the court in accordance with Bankruptcy Rule 1007 all property claimed as exempt under § 522 of the Code. FED. R. BANKR. P. 4003. This declaration of exemptions found in the statement of assets and liabilities must be debtor and a debtor's spouse in community property that is under the sole, equal, or joint management of the debtor is included in the estate.[34] Furthermore, inheritances that come to a debtor within 180 days after the filing of the petition, an interest in property because of a divorce decree or property settlement agreement with a debtor's spouse, the proceeds of a life insurance policy or death benefit plan, and the proceeds, rents, and profits from property included in the estate are all included in the definition of property of the estate.[35] It is this property of the estate that is subject to administration under the BC and is used to satisfy, among other things, prepetition claims.[36]

The general rule is that the creation of a bankruptcy estate under BC section 541 has no tax significance.[37] Thus, any transfer of property by operation of law from a debtor to the estate, other than by sale or exchange, is not a taxable event under the IRC. As a result, no gain or loss needs to be recognized upon a transfer pursuant to BC section 541—a bankruptcy filing is not a realization event.[38] Moreover, there is no change in the basis of any asset transferred. Although the transfer is technically a nontaxable event for the debtor, the debtor does lose the benefit of certain tax attributes that automatically inure to the bankruptcy estate.[39] A major exception to the general rule, however, exists where an individual debtor files for relief under chapter 7 or 11. For example, under IRC section 1398, an individual debtor's chapter 7 or chapter 11 estate is a new taxable entity separate from the individual debtor. The precise meaning of this concept is explored below.

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filed with, or within 15 days after the filing of, the bankruptcy petition unless the court extends the time for filing for cause shown. *Id.* If a debtor fails to claim exemptions, a dependent of the debtor may file the list of exemptions within 30 days after the debtor's initial time limit has run. *Id.* Thus, the Bankruptcy Rules recognize that those other than a debtor are affected by the bankruptcy case and have an interest in a debtor's fresh start even where a debtor has none.

A trustee or any creditor may file objections to the list of exemptions claimed by a debtor. *Id.* Any objection must be filed within 30 days after the conclusion of the first meeting of creditors under BC § 341 or the filing of any amendment to the list unless the court grants additional time. *Id.* Under Rule 4003, the party objecting to the exemptions has the burden of proof. Moreover, any objection filed with the court must be served on the trustee, the party claiming the exemptions (usually the debtor), and that party's attorney. *Id.*

34. 11 U.S.C. § 541(a)(2).

35. *Id.* § 541(a)(5)-(6).

36. *Id.* § 726 (1986).

37. I.R.C. §§ 1398(f)(1), 1399 (1988).

38. The realization requirement embodied in the IRC and in relevant case law provides an administrative trigger for when a tax is imposed. Thus, what constitutes a realization event for tax purposes is generally within the power of Congress to decide. *See* I.R.C. § 1001(a) & (c) (1988) (governing gain and loss computation and recognition). *See generally* DODGE, *supra* note 6, at 154 (discussing scope of realization requirement and congressional power with respect to that requirement). The realization requirement mandates that gains and losses are taxed when realized, not as the gains and losses accrue. *Id.*

39. *See* I.R.C. § 1398(g) (1988) (listing specific items that are attributed to debtor and that must be succeeded to or taken into account by estate).

A. *Prior Law*

Before enactment of the BTA in 1980, there existed no provision regarding the tax treatment of an individual's bankruptcy estate.[40] The treatment of an individual debtor's bankruptcy estate was often inconsistent, incoherent, and unclear.[41] The Service asserted that under the Bankruptcy Act, the individual's estate was taxable as an estate under IRC section 641.[42] The Service drew no distinction among straight or liquidation proceedings under Chapter VII, arrangements under Chapter XI, and real property arrangements under Chapter XII.[43]

B. *Section 1398 of the Bankruptcy Tax Act of 1980*

As part of the BTA, Congress enacted IRC section 1398. Section 1398 applies to any case under chapter 7 or chapter 11 where the debtor is an individual.[44] The import of section 1398 is that where it applies, the bankruptcy estate is treated as a separate taxable entity that may incur and should pay its own tax liabilities.[45] Thus, upon an individual debtor's filing for relief under chapter 7 or chapter 11, the bankruptcy estate becomes a new taxable entity separate from the individual debtor. However, if the case is later dismissed, section 1398 does not apply.[46] Thus, upon dismissal of the bankruptcy case, a previously-made short-year election[47] is extinguished and certain taxes incurred by the estate as a result of taxable transactions occurring within the estate pass back to the debtor.[48]

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40. Although the Bankruptcy Act of 1898 (as amended) in Chapter X (reorganization), Chapter XI (arrangements), Chapter XII (real property arrangements by persons other than corporations), and Chapter XIII (wage earner plans) contained tax provisions regarding the treatment of discharged income, it was silent as to the tax treatment of an individual's bankruptcy estate. Bankruptcy Act of July 1, 1898, ch. 451, 30 Stat. 544, *repealed by* P.L. 95-598.

41. *See generally* GRANT W. NEWTON & GILBERT D. BLOOM, BANKRUPTCY & INSOLVENCY TAXATION § 4.1, at 100 (1994) (describing confusion existing prior to enactment of BTA of 1980 regarding types of returns that must be filed for individuals and partnerships and creation of separate entity).

42. Rev. Rul. 72-387, 1972-2 C.B. 632; Rev. Rul. 68-48, 1968-1 C.B. 301. *See generally* NEWTON & BLOOM, *supra* note 41, § 4.1, at 100 (noting courts generally do not require chapter 7 trustee to file fiduciary tax return for individual's bankruptcy estate).

43. Rev. Rul. 68-48, 1968-1 C.B. 301.

44. I.R.C. § 1398(b)(1) (1988). A partnership is not an individual for § 1398 purposes. *Id.* § 1399 (1988). However, an individual debtor's interest in a partnership is treated in the same manner as other property of the debtor. *Id.* § 1398(b)(2).

45. *Id.* § 1398(c).

46. *Id.* § 1398(b)(1).

47. For an explanation of the short-year election under I.R.C. § 1398(d)(2), see MICHAEL L. COOK ET AL., FEDERAL TAX ASPECTS OF CANCELLATION OF INDEBTEDNESS INCOME AND FORECLOSURE §§ 8.03-04 (1993) and NEWTON & BLOOM, *supra* note 41, § 4.13.

48. 26 U.S.C.A. § 1398(d)(2)(A) (West 1988); Paul B. Geilich, *Essentials of Bankruptcy Tax Law*, 66 AM. BANKR. L.J. 323, 329 (1992). Not all taxes incurred by the estate pass back to the debtor; rather, the debtor is obligated to file amended returns for the taxable years in question, reporting both income and losses realized by the estate, but presumably subject to exclusions where the estate is not allowed to exclude such income, as with the sale of the debtor's principal residence. Further, such income would be included with any losses recognized by the debtor

The transfer of property pursuant to BC section 541(a), other than by sale or exchange, from the debtor to the new section 1398 taxable entity (the bankruptcy estate) is not a taxable event.[49] The estate is treated as the debtor with respect to the transferred property. Thus, any gain or loss realized by the estate will have the same character as though the property were still held by the debtor.[50] Furthermore, specific enumerated tax attributes of the debtor pass to the estate under section 1398(g). Presently, these tax attributes include net-operating loss carryovers as determined under IRC section 172; excess charitable contribution carryovers as determined under IRC section 170(d)(1); the recovery of tax benefit items under IRC section 111; certain credit carryovers; capital loss carryovers determined under IRC section 1212; the basis, holding period, and character of property; the debtor's method of accounting; and other tax attributes of the debtor, to the extent provided in regulations carrying out the purposes of section 1398.[51] Recently, the Service corrected two glaring errors by issuing proposed regulations adding passive activity and at-risk activity losses and credits to the list of tax attributes that pass from a debtor to the estate.[52] After the petition is filed, the debtor may not use any of the tax attributes that were transferred to the estate. The transfer of enumerated tax attributes recognizes that although the estate is responsible for the tax liability related to the debtor's assets, the bankruptcy estate also can use the debtor's tax attributes to reduce this liability.[53]

Section 1398 furthers the fresh start policy embodied in the BC for individual debtors. The Committee Reports recognized that the purpose of bankruptcy is to provide for a debtor's ability to begin anew his or her eco-

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both pre- and postpetition, thus potentially avoiding any tax on income realized and recognized by the bankruptcy estate.

49. I.R.C. § 1398(f)(1) (1993); *see also* Rev. Rul. 90-25, 1990-1 C.B. 47 (holding that IRC § 1398(f)(1) applies to transfer of asset from debtor to estate, and that estate shall be treated as debtor would be with respect to such asset); *see generally* Blake D. Rubin, *Tax Planning for the Debtor in Bankruptcy*, 19 J. REAL EST. TAX'N 322, 326 (1992) (analyzing tax considerations in bankruptcy).

50. I.R.C. § 1398(g)(6) (1993).

51. *See* C. RICHARD MCQUEEN ET AL., FEDERAL TAX ASPECTS OF BANKRUPTCY §§ 3.10-.12 (Supp. 1993) (providing helpful explanation of listed attributes). Because the tax attributes that pass from a debtor to his or her estate must be identified in IRC § 1398(g) or in a regulation, the list of attributes quickly becomes stale. *See* Richard M. Lipton, *Proposed 1398 Regs. Raise Conflict Between Debtors and Bankruptcy Trustees*, J. TAX'N 12, 12-13 (July 1993). *But see* 1A COLLIER ON BANKRUPTCY ¶ 9.04, at 9-25 (Lawrence P. King ed., 15th ed. 1993) (suggesting that tax attributes other than those in IRC § 1398(g) pass to estate through BC § 541).

52. *See* Prop. Treas. Reg. §§ 1.1398-1 to -2, 57 Fed. Reg. 53300 (1992) (proposing income tax regulations under IRC § 1398 relating to application of §§ 469 and 465 to the bankruptcy estates of individuals). For an example of the harm to the estate resulting from the failure to include passive activity and at-risk activity lossses and credits, see Lipton, *supra* note 51, at 13. The proposed regulations apply to all cases filed after November 9, 1992. *See* Juliann Avakian-Martin, *Witnesses Give Mixed Advice on Bankruptcy Regulations*, 58 TAX NOTES 536, 536 (Feb. 1, 1993) (discussing Jan. 25, 1993 Service hearing on improving proposed regulations under IRC § 1938).

53. *See* Lipton, *supra* note 51, at 12.

nomic life.[54] Congress recognized that any expenses incurred by the estate should not burden a debtor's fresh start. Consistent with this purpose is the section 1398 requirement that the income and losses of the bankruptcy estate, a separate taxable entity, be computed separately from those of the individual debtor.[55] Moreover, any estate tax liability is generally confined to the estate and its assets.[56] Furthermore, by making the short-year election, a debtor could shift at least part of his or her tax liability to the estate as a BC section 507(a)(7) priority claim.[57] As a priority claim, the tax liability will be paid in full before any payments are received by the unsecured creditors. Of course, any unpaid balance of tax liability is nondischargeable under BC sections 523(a)(1)(A) and 507(a)(7)(A)(i).

Consistent with its separate entity status, an estate computes its own taxable income in the same manner as an individual.[58] The estate is taxed at the same rate as a married individual filing separately.[59] The chapter 7 or 11 trustee is required to file all returns required by law and to pay all taxes due.[60] The trustee must file a return for each taxable year that the estate's gross income exceeds the standard deduction and the exemption amount.[61] Even if the estate generates no income from sales or the operation of a business, the estate may be liable for taxes generated by cancellation of indebtedness income or by sale and exchange (for example, a foreclosure on property that is property of the estate).

54. S. Rep. No. 1035, 96th Cong., 2d Sess. 24-25 (1980). *See generally* Robert W. Van Amburgh, *Tax Considerations for an Individual Debtor Contemplating Bankruptcy*, Annals Bankr. L. 93, 121-28 (discussing separate taxable entity status of bankruptcy estate).

55. *See* Rubin, *supra* note 49, at 326 (discussing tax consequences of separately taxable estate under IRC § 1398(b)).

56. I use the modifier "generally" to account for the possibility of imposing transferee liability under IRC §§ 6901, 6903, especially in situations where debtors file self-liquidating chapter 11 plans with substantial exempt property. To date, the Service has not advanced this argument.

57. *See* I.R.C. § 1398(d) (1993) (relating to the computation and payment of estate tax); *see also* 1A Collier on Bankruptcy, *supra* note 51, ¶ 9.05 (analyzing the short period election under IRC § 1398).

58. I.R.C. § 1398(c)(1); *see also* Rubin, *supra* note 49, at 326 (noting estate computes income same as individual and pays tax at "married individuals filing separately" rate).

59. I.R.C. § 1398(c)(2)-(3).

60. Stand. Fed. Tax Rep.: Tax Focus No.1 (CCH) 2 (Jan. 27, 1993). If the bankruptcy estate has gross income of $5300 or more for the year, it must file its own income tax return on Form 1041. *Id.* For a thorough treatment of a bankruptcy trustee's tax reporting and compliance duties, see 1A Collier on Bankruptcy, *supra* note 51, ¶ 10.03; James L. Shepard, The Trustee's Bankruptcy Tax Manual 1-27 (1992) (discussing federal taxation duties and liabilities for bankruptcy trustee); John Howard, *An Overview of the State & Federal Tax Responsibilities of Bankruptcy Trustees & Debtors*, 93 Com. L.J. 43 (1988); *see also* Geilich, *supra* note 48, at 323-24 (providing detailed analysis of commonly encountered bankruptcy tax issues).

61. *See* Van Amburgh, *supra* note 54, at 122 (discussing tax treatment of bankruptcy estate). For 1993, the basic standard deduction for a married individual filing a separate income tax return is $3175 with an exemption amount of $2450. Rev. Proc. 93-49, 1993-42 I.R.B. 18. Thus, the bankruptcy estate is not required to file returns until it has received gross income of $5625 or more. I.R.C. § 6012(a)(9).

The bankruptcy estate's gross income includes the gross income of the debtor to which the estate is entitled under BC sections 541(a)(1) through (a)(7). Thus, besides its own income, the estate must include as gross income any income to which the debtor had a right upon filing bankruptcy, but which did not accrue or was not received by the debtor before the commencement of the case.[62] Thus, section 1398 was intended to override the assignment-of-income principles under tax law.[63] Nonetheless, section 1398 does not allow double counting of income or losses by both the estate and the debtor. Thus, section 1398(e)(2) provides that a debtor's gross income for any taxable year does not include any item to the extent it is included in the estate's gross income.[64] Section 1398(e)(1) provides that gross income of the estate does not include any amount received by, or accrued to, the debtor before the commencement of the case.

An example may clarify the effect of section 1398. Assume that a cash-basis individual who draws a weekly salary that is nonexempt from creditors under applicable state law earns one payment before the commencement of his or her chapter 7 case, but that such payment is received by the estate after commencement. The estate and not the debtor would report the income.[65]

Whether the debtor or the estate reports cancellation of indebtedness income will depend on when the taxable event occurs. If the taxable event (e.g., complete or partial discharge, modification of principal amount, etc.) occurs before the commencement of the case, generally the debtor should recognize the income under IRC section 61(a) unless it can be excluded under IRC section 108(a).[66] If the taxable event occurs after commencement of the case, however, then the estate should recognize the income under section 61(a) unless it can be excluded under section 108(a).

IRC section 108(a) provides that a bankruptcy debtor *or* insolvent taxpayer may exclude cancellation of indebtedness income in certain situations. The bankruptcy debtor may exclude cancellation of indebtedness income to the extent the debt was discharged pursuant to court order or plan of reorganization approved by the court. The insolvent taxpayer may exclude

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62. *See* I.R.C. § 1398(c), (e) (1993) (relating to computation and payment of tax of estate, and estate's treatment of income, deductions, and credits).

63. *See* Richard C. Onsager, *Assigning Tax Liability Between the Bankruptcy Estate and the Individual Debtor*, J. TAX'N 102, 103 (Aug. 1991) (providing detailed analysis of relationship among bankruptcy estate, individual debtor, and § 1398).

64. *See generally* 1A COLLIER ON BANKRUPTCY, *supra* note 51, ¶ 9.04[3] (gross income of bankruptcy estate includes all debtor's gross income which bankruptcy estate is entitled to receive pursuant to BC and all income received by estate following commencement of case).

65. *See* Van Amburgh, *supra* note 54, at 123 (discussing and providing examples of § 1398's accounting provisions).

66. It should be noted, however, that there is a means by which to shift at least some tax consequences from the debtor to the estate through a § 1398(d)(2) short-year election by the debtor. Recently, the Department of Treasury issued temporary regulations requiring certain financial entities to report cancellation of indebtedness income on Form 1099-C. Temp. Treas. Reg. § 1.6050P-1T (1993). These regulations became effective January 1, 1994, and apply to discharges after December 31, 1993.

cancellation of indebtedness income to the extent of insolvency. Section 108(b), however, provides that to the extent excluded under section 108(a), the cancellation of indebtedness income must be used to reduce enumerated tax attributes listed in section 108(b)(2).[67] Section 108(b)(2) lists the tax attributes to be reduced in the following order: (1) net-operating losses; (2) general business credits; (3) minimum tax credits; (4) capital-loss carryovers; (5) basis; (6) passive activity loss and credit carryovers; and (7) foreign tax credit carryovers.[68] Sections 108(b)(3)(A) and (B) provide that noncredit tax attributes are reduced dollar for dollar by cancellation of indebtedness income, while credit tax attributes are reduced one dollar for each three dollars of cancellation of indebtedness income.[69] Because of the forced reduction in attributes, section 108 is a rule of tax deferment and not outright exclusion.[70]

Section 1398(e)(3) provides that the determination of whether any amount paid or incurred by the estate is allowable as a deduction shall be made as if paid by the debtor and as if the debtor were still engaged in the trade or business that the debtor was engaged in before the commencement of the case.[71] It would appear that the same accounting method used for income should be used for deductions. Additionally, IRC section 1398(e)(3) permits the estate to characterize some of its expenditures as trade or business expenses that can be used to offset current income of the estate.[72] Furthermore, administrative expenses and any fees under 28 U.S.C. § 123 are deductible by the estate to the extent not disallowed under another IRC section.[73] If the administrative expenses cannot be used in the current year, then they may be carried back three years and carried forward seven years but limited to taxable years of the estate.[74]

Section 1398(d)(2) permits a debtor to make an election by which his or her taxable year is split into *two* taxable years.[75] This election is an important pre-bankruptcy planning tool which may be used to minimize a debtor's tax liability.[76] By timely making the election, a debtor may divide his or her taxable year into two separate years. The first taxable year ends on the day

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67. I.R.C. § 108(b) (1993).

68. *Id.* § 108(b)(2); NEWTON & BLOOM, *supra* note 41, § 2.14(a), at 51. As an alternative to attribute reduction, a taxpayer may elect to reduce the basis of depreciable property. *Id.* § 2.15.

69. I.R.C. § 108(b)(3)(A)-(B).

70. Tax attribute reductions under § 108 are reported on Form 982. Form 982 is filed with the taxpayer's return for the taxable year in which the cancellation of indebtedness income occurs or as regulations provide otherwise. *See* I.R.C. § 108(d)(9)(A) (setting forth time for making election). *See generally* Kenneth C. Weil, *Effects of Real Property Abandonments in Bankruptcy*, 70 J. TAX'N 358 (June 1989) (discussing effects of § 108 pertaining to abandonment).

71. I.R.C. § 1398(e)(3) (1993).

72. *Id.*

73. *Id.* § 1398(h)(2).

74. *Id.* § 1398(h)(2)(C).

75. Geilich, *supra* note 48, at 329-30; Rubin, *supra* note 49, at 327-28.

76. *See generally* Onsager, *supra* note 63, at 105-06.

before the bankruptcy case was commenced.[77] The second taxable year begins on the commencement date. The effect of the short-year election is to make the current year's taxes a section 507(a)(7) priority claim of the estate.[78] For example, assume an individual calendar-year taxpayer/debtor files for relief under chapter 7 on March 8 and shortly thereafter timely makes the IRC section 1398(d) election. In this case the debtor has two tax years. The first year spans from January 1 through March 7 and the second year spans from March 8 through December 31. If the election were not made the debtor would have one taxable year spanning from January 1 through December 31. In other words, absent the election, the commencement of the case will not interrupt the debtor's taxable year.[79] Thus, the current year's taxes would not constitute a valid claim against the estate; the taxes would not be affected by the bankruptcy case. A debtor is considered to have made a short-year election if he or she timely files a complete tax return for the short period.[80] In our example, the return for the short period ending March 7 should be filed by July 15.

The short-year election must be made by a debtor on or before the due date for filing his or her return for the short-taxable year.[81] IRC section 6072 requires that returns be made on or before the fifteenth day of the fourth month following the close of a fiscal year.[82] A treasury regulation places a gloss on section 6072 in this context by requiring that the short-term return be filed on or before the fifteenth day of the fourth *full* month following the close of the taxable year.[83] The election must be made on the return.[84] Once made, the election is irrevocable.[85]

The short-year election is one of the most potent pre-bankruptcy planning tools because of its wide availability to individual debtors. The most significant effect of the election is that any tax liability for the first short-year becomes an allowed BC section 507(a)(7) priority claim against the estate. Thus, a debtor may essentially force his or her unsecured creditors to pay all or part of the current year's tax claims. Of course, if there are insufficient assets to pay the current year's tax claims in full, they survive the bankruptcy

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77. A bankruptcy case is commenced upon the filing of a petition under BC §§ 301-04.

78. *See* Onsager, *supra* note 63, at 105.

79. *See* I.R.C. § 1398(d)(1) (1993). The debtor cannot make the short-year election if he or she has no assets other than exempt property. I.R.C. § 1398(d)(2)(C); *see also* Onsager, *supra* note 63, at 106.

80. *See* Temp. Treas. Reg. § 7a.2(d) (1981) (discussing manner of making election); Treas. Reg. § 1.6081-1(b)(2) (1994).

81. I.R.C. § 1398(d)(2)(D).

82. I.R.C. § 6072 (1993).

83. Temp. Treas. Reg. § 7a.2(d).

84. The debtor should conspicuously write "SECTION 1398 ELECTION" at the top of the return. Temp. Treas. Reg. § 7a.2(d). For a lucid discussion on requesting extensions to file the short-year return, see 1A COLLIER ON BANKRUPTCY, supra note 51, ¶ 9.05[4][b]. *See generally* Shepard, *supra* note 60, at 157-58 (discussing procedures for debtor's election to terminate taxable year).

85. I.R.C. § 1398(d)(2)(D).

as a nondischargeable claim under BC sections 523(a)(1) and 507(a)(7)(A)(i). If the debtor fails to make the election, then any tax liability for the complete year is not an allowable claim against the estate, even though the taxes relate to income earned before the commencement of the case.[86] Moreover, if a debtor makes the election, then the debtor's tax attributes as of the end of the first taxable year are transferred to the estate to be used by the estate to shelter income. If the election is not made, the debtor's tax attributes as of the end of the full taxable year after commencement carry over to the debtor.[87]

There are no easy answers to the questions posed by IRC section 1398(d)(2). Whether a debtor should make the IRC section 1398(d)(2) election depends on the particular facts and circumstances of each case. Thus, a categorical approach to this planning issue is unwise. Generally, it appears that in most cases the election should be made.[88] By making the election, a debtor can shift at least some tax liability to the estate as an allowable BC section 507(a)(7) priority claim.[89] However, if the claim is not satisfied, it is nondischargeable and survives the bankruptcy.

Some circumstances, such as the presence of net operating losses, may dissuade a debtor from making a section 1398 election. Although such a discussion is beyond the scope of this article, a rule of thumb provided by Van Amburgh may be useful:

> If the debtor will benefit more from (i) the use of a net operating loss carried forward from the first short year (if he makes the election) to directly or indirectly reduce nondischargeable tax liabilities than from (ii) the use of the net operating loss against projected income of the debtor after the filing of the petition, then the election should be made. Otherwise the election should not be made.[90]

Please recall that to avail oneself of the section 1398 election, a debtor must affirmatively elect to do so in a timely fashion. This affirmative election requirement is unfortunate and misguided, however, since the vast majority of debtors should make the election. Many will not make the election

86. *See* S. REP. NO. 1035, 96th Cong., 2d Sess. 26 (1980) (discussing tax ramifications of debtor's election to close taxable year); *see also* Rubin, *supra* note 49, at 327 (discussing tax ramifications of debtor making § 1398(d)(2) election to terminate taxable year).

87. *See* Stand. Fed. Tax Rep.: Tax Focus No.1 (CCH) 3 (Jan. 27, 1993) (discussing tax aspects of bankruptcy and types of bankruptcy protection available).

88. Van Amburgh, *supra* note 54, at 144; *see also Shepard supra* note 60, at 150-57 (discussing benefits of debtor's election to terminate taxable year).

89. This is important because not all unsecured claims are treated equally in bankruptcy. For example, BC § 507 grants certain unsecured claims priority over general unsecured claims. *See* 11 U.S.C. § 507(a)(1)-(8) (1993) (setting forth order in which unsecured claims are paid); *see also id.* § 503(b) (1993) (providing administrative expense priority for certain unsecured claims). These priority claims must be paid in full before the unsecured claimants may participate in the distribution of the estate. *See id.* § 726 (1993) (setting forth estate property distribution order).

90. Van Amburgh, *supra* note 54, at 145; *see also* 1A COLLIER ON BANKRUPTCY, *supra* note 51, ¶ 9.05[3] (discussing the significance of § 1398 short period elections when taxpayer has no operating loss carryovers); SHEPARD, *supra* note 60, at 150-57; Rubin, *supra* note 49, at 328 (discussing positive and negative aspects of making § 1398(d)(2) election).

though, not because of some failed pre-bankruptcy tax strategy, but because of their lawyer's neglect or lack of understanding of IRC section 1398.[91] The better approach would be to require a debtor to *elect out* of the short-year treatment. This modification more accurately reflects the realities of most individual bankruptcies.

In the case of a termination of a debtor's estate, a transfer (other than by sale or exchange) of an asset from the estate back to a debtor is not a taxable event.[92] Similarly, in the case of a termination of the debtor's estate, the debtor succeeds to the unused tax attributes earlier passed to the estate.[93] Section 1398, however, is silent on what constitutes a "termination" of a debtor's estate. Clearly, when the case is closed under BC section 350, the debtor's estate has terminated.[94] The question, however, is whether something short of a closing may constitute a termination. This question is explored in Part IV below.

III. The Power of Abandonment

A trustee's[95] power to abandon property of the estate is codified in BC section 554. Under section 554, the trustee, after notice and a hearing,[96] may abandon any property of the estate that is burdensome to the estate to administer or that is of inconsequential value and benefit to the estate.[97] A bankruptcy trustee exercises the power of abandonment for the benefit of the estate to maximize recovery for unsecured creditors.[98] "In matters between creditors and the bankrupt [debtor] it is his [trustee's] duty to care for the interest of the creditors and not that of the bankrupt."[99] The legislative history suggests that abandonment may be to any party with a possessory interest in the property.[100] Although, as a theoretical matter, a party other

91. *Cf. In re* Kreidle, 146 B.R. 464 (Bankr. D. Colo. 1991) (ignoring plain language of statutes defining commencement of involuntary bankruptcy case in order to "extend" time period by which debtor could make (d)(2) election), *aff'd*, 143 B.R. 941 (D. Colo. 1992).

92. I.R.C. § 1398(f)(2) (1993).

93. I.R.C. § 1398(i); *see* Prop. Treas. Regs. § 1.1398-1 to -2, 57 Fed. Reg. 53300 (1992) (proposing income tax regulations under IRC § 1398 relating to application of § 469 passive activity losses and credits and § 465 at-risk losses to bankruptcy estates of individuals). The Service has been justifiably criticized for its delay in adding tax attributes to the § 1398 list. One distinguished commentator has suggested adding investment interest deductions, suspended S corporation losses, and percentage depletion carryovers. *See* Lipton, *supra* note 51, at 13 (discussing possible ramifications of proposed § 1398 regulations).

94. In a private letter ruling, the Service equated "termination" under IRC § 1398(f)(2) with closing a case under BC § 350. Although similar, the concepts are not congruous.

95. Under BC § 1107, a debtor in possession in a chapter 11 case is vested with the powers of a trustee including, among others, the power of abandonment. 11 U.S.C. § 1107 (1993).

96. *See* 11 U.S.C. § 102(1) (1993) (defining "after notice and a hearing").

97. *Id.* § 554.

98. *See* Frank O. Loveland, Loveland on Bankruptcy § 375, at 733-34 (4th ed. 1912) (discussing how trustee in bankruptcy represents debtor and creditors).

99. Loveland, *supra* note 98, at 735.

100. *See* S. Rep. No. 95-989, 95th Cong., 2d Sess. (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787 *and* 11 U.S.C. § 554 (1993). A bankruptcy abandonment pursuant to § 554 is not congru-

than a debtor may hold a possessory interest in the property (for example, a lessee), most often the only possessory interest in the property is held by the debtor as property owner.[101] Nonetheless, it should be recognized that, even if the debtor is the party with the possessory right to the property, abandonment chiefly concerns valuable property that is overencumbered with liens. Therefore, once abandonment occurs, a secured party almost always appears seeking to foreclose on the property.

A. *Abandonment Under the Bankruptcy Act*

The Bankruptcy Act of 1898 did not specifically provide for the abandonment of property.[102] Nevertheless, numerous cases implied a power of abandonment in a trustee.[103] The implied power is a corollary to the long-standing duty imposed on all bankruptcy trustees to administer estate assets for the benefit of estate claimants. Property that was exempt from the claims of creditors, costly to preserve, or overencumbered, was a likely candidate for abandonment. It had "long been a recognized principle of bankruptcy law that a trustee is not bound to take property of an onerous or unprofitable character, or property which will be a burden instead of a benefit."[104] The retention of these types and categories of property provided little benefit to creditors.[105] Professor Loveland suggested that estate property with no value to the creditors is not a "real asset" of the debtor.[106]

Under the Bankruptcy Act, abandonment did not affect the substantive rights in, or title to, the property.[107] The abandoned property was treated as

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ous to a taxpayer's abandonment of an asset giving rise to a deductible loss. *See* Treas. Reg. §§ 1.165-(2)(a), 1.167(a)-8(a)(4) (1994).

101. *See In re* Dewsnup, 87 B.R. 676, 681 (Bankr. D. Utah 1988) (noting debtor normally holds possessory interest in property prior to bankruptcy filing), *aff'd on other grounds*, 908 F.2d 588 (10th Cir. 1990), *aff'd sub nom.*, Dewsnup v. Timm, 112 S. Ct. 773 (1992).

102. *See In re* Pepper Ridge Blueberry Farms, 33 B.R. 696 (Bankr. W.D. Mich. 1983) (commenting that prior to Bankruptcy Rules of 1973, no statute or rules mentioned right to abandon property). In fact, the power of abandonment was a blend of the 1898 Bankruptcy Act sections, former Bankruptcy Rules, and case law. Bankr. Act §§ 64(a)(4), 70(a)(2),-(b), 77(b),-(c)(6), 187; Bankr. R. 608 (1973), *superseded by* Bankr. R. 6007; Brown v. O'Keefe, 300 U.S. 598, 602 (1937). *See generally* NORTON BANKR. L. & PRAC. § 39.01 (1984) (noting that prior to Bankruptcy Act, abandonment was governed by scattered sections, case law, and former bankruptcy rules).

103. *See, e.g., In re* A & T Trailer Park, Inc., 53 B.R. 144, 146 (Bankr. D. Wyo. 1985) (noting that prior to 1978 Bankruptcy Reform Act, many courts gave trustee implied power of abandonment in liquidation cases); *see also* 1A Bankr. Serv. L. Ed. § 4:114 (noting long line of cases implying abandonment power under Act). Commentators also recognized the inherent power to abandon under the Act. LOVELAND, *supra* note 98, § 375; JAMES A. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY § 128 (1956).

104. LOVELAND, *supra* note 98, § 375, at 773.

105. *See A & T Trailer Park*, 53 B.R. at 146 (holding mobile park of no value to estate when its present market value was $400,000 less than property's mortgage and trustee continued to incur expenses in maintaining property).

106. LOVELAND, *supra* note 98, § 375, at 773.

107. *Cf. In re* Caron, 50 B.R. 27, 31-32 (Bankr. N.D. Ga. 1984) (noting that issues of ownership and possession of property should not be determined in § 554 abandonment procedure).

if it had never been property of the estate.[108] Courts held that abandonment by a trustee immediately revested title of the asset in the debtor.[109] Although courts agreed as to the effect of abandonment, they did not reach a consensus as to precisely how the effect was achieved. Much of the confusion can be traced to the peculiarities under the Bankruptcy Act. Under the Act, title to property of a bankrupt remained in the bankrupt until a trustee was appointed and qualified.[110] Nonetheless, this title in the bankrupt during the interval between the adjudication of the bankrupt (debtor) and the appointment of the trustee was defeasible.[111] Thus, upon appointment and qualification, a trustee was vested by operation of law with the bankrupt's title as of the adjudication date.[112]

Professor Leonard Long has shown that courts generally embraced one of two legal fictions regarding bankruptcy abandonment under the Bankruptcy Act of 1898.[113] Many courts indulged in the legal fiction that upon abandonment of the asset, the debtor's interest in the property "related back" as of the filing of the petition. For example, in *Schram v. Tobias*,[114] the court stated that "[u]pon abandonment of an asset by a trustee in bankruptcy whatever inchoate title or interest passed to him is extinguished by relation back to the filing of the bankruptcy petition, leaving title as it stood just prior to the filing of the bankruptcy petition."[115] Most contemporary commentators accept the relation-back doctrine as a means of analyzing the chain of title to abandoned property under the present BC. The debtor was treated as though he or she had continuously owned the abandoned asset.[116] That doctrine, however, was not the only legal fiction used by courts. The second legal fiction used by courts provided that the original transfer from

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108. *See* Mason v. Commissioner, 646 F.2d 1309, 1310 (9th Cir. 1980) (noting abandoned property treated as if bankrupt owned property continuously); *In re* Cruseturner, 8 B.R. 581, 591-92 (Bankr. D. Utah 1981) (noting debtor's claims and interests in property are same as prior to bankruptcy filing when trustee abandons property); *see also* Leonard J. Long, *Burdensome Property, Onerous Laws, and Abandonment: Revisiting* Midlantic National Bank v. New Jersey Department of Environmental Protection, 21 HOFSTRA L. REV. 63, 91-92 (1992) (noting property abandoned by trustee treated as if no bankruptcy had been filed).

109. *See, e.g.*, *In re* Thomas, 204 F.2d 788, 792 (7th Cir. 1953) (noting title revests in bankrupt upon abandonment by trustee); *In re* Polumbo, 271 F. Supp. 640, 643 (W.D. Va. 1967) (noting trustee's abandonment of asset immediately revests title to asset in bankrupt).

110. *See* Bankruptcy Act of 1898 § 70a, *superseded by* 11 U.S.C. § 541; *see, e.g.*, Conner v. Long, 104 U.S. 228, 230 (1881) (noting bankrupt retains title until assignee is appointed and qualified); *see also* LOVELAND, *supra* note 98, § 368, at 757 (same).

111. *See* LOVELAND, *supra* note 98, § 368, at 758 (commenting that title of bankrupt is defeasible between adjudication and appointment of trustee).

112. *See* LOVELAND, *supra* note 98, § 370, at 761 (noting appointed and qualified trustee vested by operation of law with title of bankrupt as of date of adjudication). This was one major difference between the 1898 Act and the 1867 Act. *Id. See generally* 4 COLLIER ON BANKRUPTCY, *supra* note 51, ¶ 541.02.

113. LONG, *supra* note 108, at 91-92 & n.83.

114. 40 F. Supp. 470 (E.D. Mich. 1941).

115. *Id.* at 472.

116. Wallace v. Lawrence Warehouse Co., 338 F.2d 392, 394 n.1 (9th Cir. 1964) (citing Sessions v. Romadka, 145 U.S. 29 (1892)).

the debtor to the estate upon the filing of the petition never occurred in the first place.

Which of the two abandonment theories under the former Bankruptcy Act provided the more compelling analysis? The refreshing answer to this question is that courts operating under the Bankruptcy Act did not care. They recognized the two doctrines as convenient legal fictions enabling courts to decide particular issues at hand.

> Abandonment completely divests the trustee of all right [sic] in the property. The title is thenceforth regarded as the bankrupt's just as if he had never been in bankruptcy. Whether the title passes to the trustee and revests in the bankrupt, or never passes from the bankrupt, since the trustee rejects the title, is of no importance here.[117]

These legal fictions were never meant to end the analysis of what exactly happens to title in abandoned property; courts used them as a "convenient way of describing a situation where the trustee never had occasion to proceed and the right is viewed . . . as remaining in the bankrupt."[118] This history is important to understanding the tax consequences of abandonment under the BC because much contemporary analysis blindly accepts the relation-back doctrine without recognizing a counter-tradition, and without acknowledging the limited purpose of the doctrine in the first place.

Although courts viewed the question regarding the effect of property abandonment in bankruptcy as unnecessary, commentators nevertheless analyzed the issue with great care. For example, two distinguished 1898 Act commentators, Professors Loveland and MacLachlan, determined that upon abandonment, title to the property *remains in the bankrupt.*[119] These commentators believed the doctrine of relation back was unnecessary because the bankrupt's interest had remained in the property all along. Thus, when a trustee abandons property, he or she disclaims the estate's interest in it.[120]

B. *Abandonment Under the Bankruptcy Code*

The Bankruptcy Reform Act of 1978 essentially codified the implied power of abandonment long-recognized under the 1898 Act. BC section 554 recognizes three methods by which estate property may be abandoned. First, a trustee may abandon estate property, after notice and a hearing,[121] if the property is burdensome to the estate or of inconsequential value and benefit to the estate.[122] This method is commonly called "proposed abandonment."[123] Second, any party in interest[124] may seek the abandonment of

117. *In re* Malcom, 48 F. Supp. 675, 679 (E.D. Ill. 1943) (citations omitted).

118. Rosenblum v. Dingfelder, 111 F.2d 406, 409 (2d Cir. 1940) (citations omitted).

119. LOVELAND, *supra* note 98, § 375, at 774 n.4; MACLACHLAN, *supra* note 103, § 128.

120. *See* LOVELAND, *supra* note 98, § 375 (noting bankrupt retains title when trustee elects not to take property or right).

121. *See* 11 U.S.C. § 102(1) (1993) (defining "after notice and hearing").

122. *Id.* § 554(a) (1993).

123. *In re* Rubin, 154 B.R. 897, 901 (Bankr. D. Md. 1992).

124. *See* 11 U.S.C. § 1109(b) (1993) (defining "party in interest").

estate property by order of the court where the statutory grounds are satisfied.[125] This method is commonly known as "compelled abandonment."[126] Third, scheduled estate property that is unadministered as of the close of the bankruptcy case[127] is deemed abandoned by operation of law.[128] This method is commonly called "deemed abandonment."[129] Estate property that is not abandoned pursuant to one of these three methods remains estate property unless the court orders otherwise.[130]

Abandonment is a form of estate property administration. The purpose of abandonment under the BC is straightforward. The underlying norm is to maximize the recovery of claimants. This is accomplished through the efficient reduction of estate assets to money for distribution to holders of claims and interests.[131] The power of abandonment facilitates this underlying norm by empowering a trustee with the ability to abandon burdensome or income-draining property that would deplete the estate of resources otherwise available to claimants.[132]

In summary, a proposed or compelled abandonment must meet the substantive grounds contained in BC section 554 to be effective. The property must be either (1) burdensome for the estate to administer or (2) of inconsequential value and benefit to the estate.[133] Because of the complexities inherent in administering estate assets, a trustee is granted broad discretion in seeking the abandonment of property.[134] A typical abandonment scenario is where the estate holds property subject to a secured indebtedness that exceeds the fair market value of the property. In such a situation, no value

125. *See id.* § 554(b) (providing that party in interest may request abandonment of property that is burdensome or of inconsequential value and benefit to estate); *see also In re* Paollela, 85 B.R. 974, 977 (Bankr. E.D. Pa. 1988) (noting party in interest may instigate abandonment of property).

126. *See, e.g., In re* K.C. Mach. & Tool Co., 816 F.2d 238, 243-45 (6th Cir. 1987) (referring to court-ordered abandonment on statutory grounds as "compelled abandonment").

127. The closing of a bankruptcy case is governed by 11 U.S.C. § 350 (1993).

128. 11 U.S.C. § 554(c).

129. *See In re* Reed, 89 B.R. 100, 103 (Bankr. C.D. Cal. 1988), *aff'd*, 940 F.2d 1317 (1991) (noting all scheduled, unadministered, and non-exempt property of estate is "deemed abandoned" once bankruptcy case is closed). *But see Paollela*, 85 B.R. at 978 (noting bankruptcy court has power in appropriate circumstances to override abandonment provision).

130. 11 U.S.C. § 554(d).

131. Midlantic Nat'l Bank v. New Jersey Dept. of Envt'l Protection, 474 U.S. 494, 508 (Rehnquist, J., dissenting) (1986); *see also* 11 U.S.C. §§ 704, 725-726 (1993) (requiring trustee to reduce estate's property to money and distribute it to claim and instrument holders).

132. *Midlantic Nat'l Bank*, 474 U.S. at 508 (Rehnquist, J., dissenting). A "compelled abandonment" under § 554(b) also has the effect of preventing a trustee from retaining an estate asset solely to fund a trustee's fee. *Cf. In re* K.C. Mach. & Tool Co., 816 F.2d 238, 243-45 (6th Cir. 1987) (noting abandonment should be ordered unless trustee attempts to churn worthless property merely to increase fees).

133. 11 U.S.C. § 554(a)-(b) (1993).

134. *See, e.g.*, Yadkin Valley Bank & Trust Co. v. McGee, 819 F.2d 74, 76 (4th Cir. 1978) (noting trustee granted considerable discretion in administering estate assets); *see also* SHEPARD, *supra* note 60, at 67 (noting bankruptcy trustees are vested with considerable discretion because of complexity of bankruptcy proceedings).

remains for the unsecured creditors of the estate once the secured claim is paid.[135] Therefore, a trustee administers the property by abandoning it according to his or her fiduciary duties to the estate—in particular, the duty to maximize the recovery of the creditors.

C. Limitations on the Abandonment Power

There are several limitations on a trustee's power to abandon property under BC section 554. A first order limitation may be found in the language of BC section 554. Abandonment is not proper unless the target property is burdensome to the estate or of inconsequential value and benefit to the estate.[136] Although the determination of whether the substantive grounds in BC section 554 are met involves a highly fact-intensive investigation, certain factors have been identified as relevant to the inquiry. For example, courts will consider the cost associated with maintaining the property,[137] liquidation costs of the property,[138] any income generated by the property,[139] a debtor's equity in the property,[140] and the exemption status of the property.[141]

A second order limitation is found nowhere in BC section 554. In *Midlantic National Bank v. New Jersey Department of Environmental Protection*,[142] the Supreme Court fashioned another limitation on a trustee's ability to abandon property. In *Midlantic*, the chapter 11 trustee sought to abandon property containing hazardous waste. It was undisputed that the property in question was burdensome to the estate and income draining.[143] Admitting that the proposed abandonment met the explicit requirements under BC section 554, the Court nevertheless denied abandonment where the abandonment effectively constituted a release or disposal of hazardous waste in violation of state environmental laws. To justify its holding, the Court asserted that an *implied* limitation on the abandonment power existed in light of Congress's stated goal to protect the environment. Thus, a trustee may not abandon property in contravention of applicable nonbankruptcy law designed to protect public health and safety.[144] The Court carefully nar-

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135. The secured claim is defined by reference to the value of the underlying collateral. *See* 11 U.S.C. § 506(a) (1993) (providing that allowed claim is secured to extent of value of creditor's interest in property, and is unsecured to extent that value of creditor's interest is less than amount of allowed claim).

136. *Id.* § 554(a).

137. *See, e.g.*, *In re* A & T Trailer Park, Inc., 53 B.R. 144, 146 (Bankr. D. Wyo. 1985) (noting trustee that incurs expenses in maintaining property is authorized under § 554 to abandon property).

138. *See, e.g.*, *In re* Cahall, 1 BAMSL 107 (Bankr. E.D. Mo. 1980).

139. *See, e.g.*, *A & T Trailer Park*, 53 B.R. at 146 (noting property's ability to produce income is factor in determining whether trustee may abandon property).

140. *See, e.g.*, *In re* K.C. Mach. & Tool Co., 816 F.2d 238, 243 (6th Cir. 1987) (noting debtor's equity in property is factor in determining whether trustee may abandon property).

141. *See, e.g.*, *In re* Wilson, 2 BAMSL 245 (Bankr. E.D. Mo. 1983).

142. 474 U.S. 494 (1986).

143. *Id.* at 497.

144. *Id.* at 507.

rowed the scope of the implied limitation by insisting that the threat present an "imminent and substantial" endangerment to public health and safety.[145]

D. Effect of Abandonment

Much confusion surrounds the concept of abandonment in bankruptcy. Some of this confusion can be traced to the treatment of abandonment in the context of property and tax law. The concept itself poses interesting issues regarding the status of estate property in bankruptcy. For example, once the bankruptcy petition is filed, is the debtor's interest in property subordinated to or entirely displaced by the bankruptcy estate? Upon abandonment, does the debtor's interest "relate back" or "spring forward" in the property? Has the debtor's interest in the property always remained? What is the relationship between section 554 and the other provisions in chapter 5 of the BC? Exactly what is happening to the status of property when it becomes estate property when the petition in bankruptcy is filed?

Too often, authorities discussing the concept of estate property start and finish with BC section 541. Granted, section 541 is the core of the estate concept, but like the apple, there is more to the concept of the bankruptcy estate than its core. In particular, one cannot fully understand the concept of the estate without considering other provisions of the BC, including BC sections 544(a), 542(a), 323(a), and 363(b). For example, section 544(a), also known as the trustee's strong-arm power, endows the trustee with the status of a hypothetical judicial lien creditor or a *bona fide* purchaser of real property once the bankruptcy petition is filed.[146]

The BC does not contemplate the displacement of the debtor's interest in his or her property; rather, the BC provides for the subordination of the debtor's interest to the trustee's hypothetical judicial lien for the benefit of the estate. Thus, by operation of the BC, the transfer from debtors to bankruptcy estates should be characterized more like a transfer by a general levy upon a debtor's assets than a transfer in fee simple from debtors to the estates.[147] "[I]t would seem more of a truism than a tour de force to regard the bankruptcy as a levy upon the debtor's property for the benefit of general creditors."[148] Professor MacLachlan recognized that under the 1898 Act,

145. *Id.* at 505-06. Authorities have severely criticized *Midlantic*, disagreeing as to its appropriate scope and meaning. The emerging view is that abandonment is permitted where the public health and safety is adequately protected. *In re* Purco, Inc., 76 B.R. 523, 533 (Bankr. W.D. Pa. 1987); *see also In re* Franklin Signal Corp., 65 B.R. 268, 273 (Bankr. D. Minn. 1986) (noting trustee must take minimal steps to protect public). *But see In re* Smith-Douglass, Inc., 856 F.2d 12, 16 (4th Cir. 1988) (noting risk must be serious and not speculative).

146. 11 U.S.C. § 544(a)(1)-(3). For a thorough article on BC § 544, see generally David G. Carlson, *The Trustee's Strong Arm Power Under the Bankruptcy Code*, 43 S.C. L. REV. 841, 842 (1992) (noting trustee's status as judicial lien creditor is natural adjunct to bankruptcy).

147. MACLACHLAN, *supra* note 103, § 183, at 186-87.

148. *Id. See generally* David G. Carlson, *Successor Liability In Bankruptcy: Some Unifying Themes of Intertemporal Creditor Priorities Created By Running Covenants, Products Liability and Toxic-Waste Cleanup*, 50 J. L. & CONTEMP. PROBS. 119, 151 n.139 (1987) (noting bankruptcy trustee is secured creditor in personal property).

section 70c (the precursor to BC section 544(a)) should be regarded as "rounding out the concept that bankruptcy is a general levy upon the debtor's assets, so as to cover assets that levying creditors might reach upon the date of bankruptcy if bankruptcy did not occur."[149] Virtually everything a trustee may do with an estate asset, a judicial lien creditor may also do under state law.[150]

The term "abandonment" has many different meanings in the law. For example, under property law, abandonment means empowerment of any stranger to take title that is good against the claims of the abandoner.[151]

> Thus, X, the owner of ordinary personal property "in a tangible object" has the power to extinguish his own legal interest . . . through that totality of operative facts known as abandonment; and—simultaneously and correlatively—to create in other persons privileges and powers relating to the abandoned object—e.g., the power to acquire title to the latter by appropriating it.[152]

Consistent with the common law's insistence that *someone* have seizin (the common law abhors a lapse in title), property law abandonment does not terminate the owner's title until some stranger asserts a better title to the property.[153]

When bankruptcy courts use the term "abandonment," they envision something very different from property law abandonment. In particular, bankruptcy abandonment under section 554 never authorizes a stranger to take title. In fact, bankruptcy abandonment mentions nothing about title at all.[154] Additionally, section 554 is not driven by the common law tradition that there be no lapses in title to property. Thus, property law and bankruptcy abandonment differ in both context and policy concerns.

Under tax law, abandonment is the equivalent of a sale or exchange under IRC section 1001(c). Section 1001(c) provides for the recognition of gain or loss on exchanges of property.[155] Tax law abandonment is a realization event. The entire amount of gain or loss on an abandonment is recognized under IRC section 1001(c), except as otherwise provided in the IRC.[156] The taxable gain is the excess of the value of the asset transferred over the adjusted basis of the asset. Thus, tax abandonment, like foreclosure, condemnation, destruction by natural

149. MacLachlan, *supra* note 103, § 183, at 188.

150. *See generally* 11 U.S.C. § 363 (1993) (providing for use, sale, or lease of estate property by trustee).

151. Carlson, *supra* note 148, at 159.

152. W. Hohfeld, Fundamental Legal Conceptions As Applied in Judicial Reasoning and Other Legal Essays 51 (1923).

153. Carlson, *supra* note 148, at 159.

154. *See generally* Norton Bankr. L. & Prac. § 39.01, at 2 (1984) (noting instances where effect of § 554 abandonment does not determine who has title to property).

155. I.R.C. § 1001(c) (1993).

156. *See generally* I.R.C. §§ 1031-39 (1988) (identifying certain nonrecognition rules).

causes, reimbursement by insurance, and deeds in lieu, triggers the rule of realization.[157] Abandonment serves this tax purpose and no other.[158]

Although property and tax law abandonment spring from a common ancestor, bankruptcy abandonment is an entirely different species. Abandonment is best viewed as a disclaimer of interest in estate property by a trustee as the representative of the estate.[159] The rights and responsibilities that existed in the property immediately before the bankruptcy filing remain with the debtor throughout the administration of the case, subject to the trustee's judicial lien power. In other words, abandonment of the property is a trustee's disclaimer of its judicial lien; a relinquishment of the trustee's rights as the representative of the creditors of the estate in the abandoned asset. The effect of a trustee's release of its judicial lien is to divest control over the abandoned asset, which is no longer property of the estate.[160] Therefore, bankruptcy abandonment is not a transfer or exchange for tax purposes any more than the release of a judicial lien is a transfer or exchange. Thus, reliance on legislative history suggesting that abandonment may be to any person with a possessory interest in the property is misplaced.[161] The legislative history merely recognizes that a non-owner debtor may nevertheless have a possessory interest in the abandoned property that may be protected by the automatic stay even where abandonment has occurred.[162]

Recognizing that by filing the petition in bankruptcy the debtor gives up control but not title to his or her property until some later event allows one to extricate bankruptcy analysis from dependence on legal fictions like the doctrine of relation back. In fact, courts have been somewhat reluctant to

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157. Realization is a rule of administrative convenience. Gain or loss could also be taxed on an ability to pay or accretion method. *See* Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 MICH. L. REV. 722, 727 (1990) (demonstrating time-value adjustments convert realization tax model into accretion tax ideal); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111, 1118 (1986) (proposing that taxpayers value all assets and liabilities and their respective gains and losses regardless of realization); Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817, 1824 (1990) (discussing tax policy problems that arise from ability of taxpayer to delay realization).

158. There is a general requirement of taxable transfers of an exchange of consideration. This requirement is generally satisfied in abandonments and transfers outside of bankruptcy by the prior loan of money and subsequent release from the obligation.

159. *See* First Carolina Fin. Corp. v. Estate of Caron (*In re* Caron), 50 B.R. 27, 31-32 (Bankr. N.D. Ga. 1984) (abandonment procedures not intended to determine issues of ownership and possession); LOVELAND, *supra* note 98, § 375, at 774 (evaluating trustee's ability to abandon worthless or burdensome property); MACLACHLAN, *supra* note 103, § 128, at 119 (recognizing trustee not bound to take property of onerous, burdening, or unprofitable character).

160. *See In re* R-B-Co., Inc., 59 B.R. 43, 45 (Bankr. W.D. La. 1986) (holding that abandonment cannot be used as means of effecting transfer of title).

161. See *supra* note 100 and accompanying text for a discussion of the legislative history behind abandonment.

162. This is so because although the property is no longer property of the estate, it is property of the debtor. As such, the property continues to be protected by the stay until the stay is terminated under § 362(d) or ceases to exist under 11 U.S.C. § 362(e) (1993). *See, e.g.*, *Caron*, 50 B.R. at 29 n.2 (recognizing abandonment alone will terminate stay only as to estate's interest in property, but not as to debtor's interest in property).

recognize the two fictions under the BC.[163] This reluctance has culminated in *United States v. Grant*.[164] *Grant* involved a debtor who was convicted for the concealment of assets in bankruptcy.[165] On appeal, debtor's counsel spun an ingenious argument based on the time-honored doctrine of relation back. Counsel argued that the debtor could not be guilty of hiding assets of the estate where the assets (some unknown to the trustee) were abandoned pursuant to a settlement agreement between the debtor and trustee.[166] Essentially, the debtor argued that he could not be guilty of concealing estate property because under the relation back doctrine, the concealed assets were treated as *never* having been property of the estate.[167] Incredibly, a panel of the First Circuit agreed and reversed the conviction.[168] Sitting *en banc*, the First Circuit reversed itself and reinstated the conviction. Obviously troubled with the application of the doctrine of relation back in the criminal context, the court stated:

> Assuming the trustee did abandon any interest of the chapter 7 estate in the [property] allegedly concealed by [the debtor], we conclude nonetheless that the doctrine of "relation back" is unavailing, as it is logically and legally inapposite to a criminal prosecution for concealing "property belonging to [a chapter 7] estate" arising under the Bankruptcy Code. . . . [The application of this doctrine] in relation to these chapter 7 proceedings under the Bankruptcy Code would serve none of the benign purposes for which it was fashioned. Rather, its extension to criminal proceedings for bankruptcy fraud arising out of a chapter 7 case would disserve the interests of justice which the "relation back" doctrine was designed to serve.[169]

In dicta, the court addressed the need and efficacy of the doctrine under the BC. It noted that the legal fiction was a convenient tool to address the apparent gap in title to property under the old Bankruptcy Act. Under the old Act, title to the debtor's property was often in limbo. The filing of the bankruptcy petition and the adjudication of bankruptcy divested the debtor of his control over the property. Thus, the debtor could not legally dispose of the property after filing the petition. Meanwhile, title would remain with the debtor until the bankruptcy trustee was appointed and qualified.[170] The doctrine of relation back was then used to fill in the gap in title between the filing of the petition and the appointment of the trustee in favor of the

163. *See, e.g.*, Jim Walter Homes, Inc. v. Saylors (*In re* Saylors), 869 F.2d 1434, 1437 n.2 (11th Cir. 1989) (holding interest held constructively reverted back to debtor); *R-B-Co.*, 59 B.R. at 45 (noting abandonment cannot be used to effect turnover, recovery, or legal title or possession to any particular creditor).

164. 971 F.2d 799 (1st Cir. 1992).

165. *See* 18 U.S.C. § 152 (1993) (listing concealment of assets as bankruptcy crime).

166. 971 F.2d at 803.

167. *Id.* at 805; *see also* Brown v. O'Keefe, 300 U.S. 598, 602 (1937) (holding title to abandoned property reverts back to debtor and such property treated as never having been property of estate).

168. 946 F.2d 1 (lst Cir. 1991), *withdrawn and superseded by* 971 F.2d 799 (1992).

169. 971 F.2d at 803-04.

170. *Id.* at 804.

trustee.[171] The court recognized that the legal fiction was no longer necessary under the BC because of the estate's creation immediately upon the bankruptcy petition filing.[172]

The First Circuit's rejection of a blind adherence to the relation back doctrine is welcomed. Nonetheless, the court erred in its contention that no court had invoked the doctrine under the BC.[173] In fact, at least one reported case used the doctrine in evaluating the tax consequences of abandonment.[174] One distinguished commentator concluded that *Grant* should be limited to criminal cases, while the doctrine should remain viable in evaluating the tax consequences of abandonment.[175] The analysis proposed in this article goes further by rejecting the relation back legal fiction altogether and characterizing it as merely unnecessary. By recognizing that the debtor retains title in estate property, albeit subordinated to the estate's right to control the property, there is no lapse in title. Furthermore, once a trustee disclaims the estate's interest in property through the exercise of his or her abandonment power (or the debtor exempts estate property), the debtor's interest in the property becomes superior to the estate's.

"[T]he trustee's status as a judicial lien creditor is a natural adjunct to the very concept of bankruptcy."[176] In fact, "the trustee in bankruptcy . . . stands here as the ideal creditor . . . armed cap-a-pie with every right and power which is conferred by the law of the state upon its most favored creditor who has acquired a lien by legal or equitable proceedings."[177]

Consistent with the concept that the estate has paramount control over and interest in estate property is the statutory turnover action in BC section 542(a). Section 542(a) provides to the estate a present possessory right to estate property, "unless such property is of inconsequential value or benefit to the estate."[178] Section 542 rounds out the concepts of the bankruptcy estate under BC section 541 and of the trustee as the ideal creditor under BC section 544(a).

Finally, the role of the bankruptcy trustee as it relates to estate property is fleshed out by BC sections 323(a) and 363(b). Recall that under section 70a of the Bankruptcy Act of 1898, title to property of the bankrupt vested in the qualified trustee.[179] The BC has eliminated the vesting of title in the

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171. *Id.*

172. *Id.* at 805.

173. *Id.* at 805 n.8.

174. *See, e.g., In re* Nevin, 135 B.R. 652, 653 (Bankr. D. Haw. 1991) (determining abandonment relates back to inception of bankruptcy case, title revests in, and taxes flow through to debtors).

175. *See* SHEPARD, *supra* note 60, at 3-4.

176. Carlson, *supra* note 146, at 842 (citation omitted).

177. *In re* Waynesboro Motor Co., 60 F.2d 668, 669 (S.D. Miss. 1932).

178. 11 U.S.C. § 542(a); *see also id.* § 543. *See generally* DOUGLAS G. BAND, THE ELEMENTS OF BANKRUPTCY 210 (2d ed. 1993). Notice that the quoted proviso of BC § 542(a) is very similar to one of the grounds for proposed and compelled abandonment. *See* 11 U.S.C. § 554(a)-(b).

179. 4 COLLIER ON BANKRUPTCY, *supra* note 51, ¶ 541.02, at 541-13.

trustee; rather, according to one commentator, "[t]itle is an interest that vests in the estate."[180] Sections 323(a) and 363(b) then provide the bankruptcy trustee with the power and authority to dispose of estate property for the benefit of the creditors of the estate.

Collier is less than clear on the subject of what exactly happens to property that becomes property of the estate. After recognizing that title to estate property no longer vests in the trustee under the BC,[181] it states that title is an interest that vests in the estate.[182] Later, Collier observes that "[u]nder the Code, which provides for the creation of an estate comprised of all interests of the debtor in property but which has abolished the concept of the vesting of title to such property in the trustee, the estate are in custodia legis from the inception of the case."[183]

What does all this mean? Is Collier suggesting that once property enters the bankruptcy estate the debtor's interest in the property is completely displaced? At one point Collier states that the debtor has no interest in estate property.[184] However, it cites no direct authority for the proposition. Outside of this direct statement, Collier's observations regarding the estate and the property comprising the estate are consistent with the theory presented in this article that the estate through the trustee has paramount title in and possessory rights to estate property, but does not displace the debtor's interest in those same assets. The theory of estate property constructed in this article is consistent with Bankruptcy Act commentators, pre- and post-BC cases, and BC sections 541, 554(a), 542(a), 323(a), and 363(b).

Moreover, the "ideal-creditor" theory proposed here more closely depicts how estate property is treated in and out of bankruptcy. For example, record title under state law to estate property remains in the name of the debtor. Although a trustee may file a notice of bankruptcy and appointment in the proper property records, no new deeds and bills of sale are filed. The trustee's notice is merely treated as a cloud on title. Of course, BC sections 323(a) and 363(b) authorize the trustee to represent the estate and to dispose of estate property.

Two other provisions of the BC also support the "ideal-creditor" model. First, and more relevant, BC section 554 essentially permits abandonment to the debtor or any other party with a possessory interest in the property. However, if the debtor has no interest in estate property, then an abandonment should generally provide the debtor no greater rights to or claim against the property than any other party. Yet, this is not the case under BC section 554. Second, all the debtor's legal and equitable interest in property, including exempt property, becomes estate property. Nonetheless, the debtor may exempt certain estate property for his or her benefit.[185] Yet, if

180. *Id.* ¶ 541.02, at 541-14.

181. *Id.*

182. *Id.*

183. *Id.* ¶541.02, at 541-23.

184. *Id.* ¶ 541.01, at 541-8 (stating why former Bankruptcy Act § 8 is no longer necessary).

185. *See* 11 U.S.C. § 522 (listing potential exemptions).

the debtor has no interest in estate property, how may he or she now claim an interest in it and a right to exempt it? The terse response is that BC section 522 permits the debtor to exempt assets notwithstanding BC section 541(a). But this analysis begins to heap one legal fiction upon another and upon another . . . and upon another. The theory proposed in this article cuts to the quick and accounts for the relevant BC provisions and the realities of the treatment of estate property.

IV. Toward a Comprehensive Model

The tax consequences of abandoning estate property is limited to individual bankruptcies under chapter 7 or chapter 11 because in those cases IRC section 1398 establishes the bankruptcy estate as a separate entity.[186] The true controversy is whether a debtor can avoid deferred taxes on overencumbered property having a low basis. Ideally, pursuant to IRC section 1398, a debtor seeks to capture the consequences of foreclosure in the estate. Thus, the tax becomes a liability of the estate and not the debtor. Simply, a debtor hopes to force its priority claimants and unsecured creditors to pay the tax while walking away from any potential personal liability.

A. *What is at Stake?*

Neither the BC nor the IRC considers the federal tax implications of property abandoned by the bankruptcy estate before closing the case.[187] However, the conflicting interests at stake may be better understood with an example. Assume that an individual debtor owns an office building subject to nonrecourse indebtedness of $1,000,000. The fair market value of the property is $500,000. The adjusted basis in the property has been reduced over time to $250,000. The debtor has incurred net-operating losses and carryovers of $250,000 related to the business property. If the lender forecloses on the property in full satisfaction of the debt, the foreclosure is a taxable event giving rise to a gain or loss.[188] Here, the amount realized by the debtor is a gain of $750,000, the difference between the nonrecourse debt and the

186. *See* I.R.C. § 1399, Priv. Ltr. Rul. 89-28-012 (Apr. 7, 1989) (providing that separate entity rules do not apply to chapter 12 estates).

187. Authorities often refer to this as "midstream" abandonment. Accordingly, 11 U.S.C. § 346(g)(1)(B) (1993) provides that, for state and local tax purposes, a midstream abandonment is not a taxable event. *See* Mark S. Wallace, *Is a Midstream Abandonment of Property by a Bankruptcy Trustee Taxable to the Estate*, 77 J. Tax'n 26, 27-28 (1992) (concluding nonrecognition treatment applies to midstream abandonment).

188. Crane v. Commissioner, 331 U.S. 1 (1946). Because the debt is nonrecourse, no cancellation of indebtedness income will arise when the property is used to satisfy the debt in full. *See* Commissioner v. Tufts, 461 U.S. 300, 304 (1983) (treating nonrecourse debtor as having sold underlying collateral for debt amount).

adjusted basis.[189] Often, this gain represents nothing more than "phantom" income.[190]

If the foreclosure occurs while the property is in the possession of the bankruptcy estate, then the estate must recognize the gain and pay the tax. In fact, the tax claim is a priority claim under BC sections 503(b)(1)(B) and 507(a)(1), which is paid in full ahead of all other priority and unsecured claims except other administrative expense claims (which share *pro rata* with the priority claim).[191] If there are insufficient assets in the estate to pay the tax, then the tax goes unpaid and the debtor is not liable for any deficiency. If the property is abandoned by the trustee before foreclosure, then the debtor must recognize the gain and pay the tax even though the tax attributes associated with the property remain with the estate to shelter estate tax liability. The opportunity to jettison burdensome or inconsequential property in these circumstances helps the trustee in his or her efforts to maximize the recovery of the unsecured creditors, but does so at the expense of the debtor.

For a thorough resolution of the central issue presented in this article, no less than five substantive provisions of the BC and two substantive provisions of the IRC must be carefully considered. The first BC provision is found at section 541. Section 541 defines what does and does not make up property of the estate.[192] The second provision is BC section 554, which delineates the grounds for proposed, compelled, and deemed abandonment in bankruptcy.[193] The third provision is BC section 523, which specifically excludes certain debts from the bankruptcy discharge, effectively subordinating the discharge right to certain creditor interests such as the interest of a taxing authority to ensure payment of the current year's taxes.[194] The fourth and fifth provisions are found at BC sections 507 and 726. Together, they identify the priority and treatment of claims in a bankruptcy case, thus accentuating what is at stake in this context.[195] The sixth provision is IRC section 1398. That section creates two separate taxable entities in certain circumstances—the estate and the debtor.[196] It is IRC section 1398 that creates the conundrum posed by bankruptcy abandonment. Finally, IRC section 108 is also relevant to the inquiry. It sets out certain rules in handling cancellation of indebtedness income.[197] All these provisions must be analyzed before a proper resolution of the issues can be reached.

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189. *See Tufts*, 461 U.S. at 317 (holding fair market value of property is irrelevant to calculation of the amount realized).

190. *See* Marc E. Grossberg, *Tax Consequences of Abandonment of an Asset of a Bankrupt Estate*, 50 N.Y.U. INST. 12-1, 12-2 (1992).

191. *See generally* Wallace, *supra* note 187, at 26 (casting doubt on whether nonrecognition treatment applies to abandonment back to debtor).

192. 11 U.S.C. § 541 (1993).

193. *Id.* § 554.

194. *Id.* § 523.

195. *Id.* §§ 507, 726.

196. I.R.C. § 1398 (1993).

197. *Id.* § 108 (1993). *See generally* James Eustice, *Cancellation of Indebtedness Redux: The Bankruptcy Tax Act of 1980 Proposals - Corporate Aspects*, 36 TAX L. REV. 1 (1981) (discussing

The issues generated by the tax consequences of abandonment thrust the bankruptcy courts into a maelstrom involving tax and bankruptcy law, sacrosanct policies embodied in the two codes, and provisions in the two codes that cannot be easily harmonized. At bottom, one encounters a core contradiction between the two ancient goals of bankruptcy clashing like mythical Titans—bankruptcy as a collective debt-collection device to facilitate an efficient recovery of claims in a way that maximizes a creditor's return, and the debtor's right to discharge (or right to reorganize in chapter 11). What results is a "bankruptcy paradox" of sorts. The task is to accommodate the policies driving the contradiction while constructing a workable model. This goal is made the more difficult and frustrating because of the failure of Congress to consider the issues posed by abandonment in enacting IRC section 1398. In analyzing the various models put forth by authorities in an attempt to resolve the difficult issues, one must not forget that those who have struggled with the issues have undertaken this task with little guidance.

B. Olson *Model*

The model of bankruptcy abandonment embraced by most courts and the Service is explicated by the Eighth Circuit in *In re Olson.*[198] In *Olson*, the court held that abandonment was not a taxable event, thus rejecting the fresh start argument embraced later by another court in *In re A.J. Lane & Co.*[199] After the debtors filed a chapter 7 petition, the chapter 7 trustee abandoned certain property that was subsequently sold by a secured creditor under state foreclosure proceedings.[200] The individual debtors hired an accountant to prepare federal and state income tax returns for the bankruptcy estate. These returns reported a gain realized from the sale of the property as a liability of the bankruptcy estate. The debtors claimed that the estate was liable for the tax. The trustee did not authorize the debtors to prepare and file the tax returns for the estate.[201]

The bankruptcy court in *Olson* observed that under IRC section 1398(f)(2), a "transfer"[202] includes the release of an estate's interest in property through abandonment.[203] Nevertheless, the bankruptcy court stopped short of accepting the debtors' argument based on an extension of the hold-

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cancellation of indebtedness income); James Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1989) (discussing tax effects to debtor when liability is discharged at less than full amount due).

198. 930 F.2d 6 (8th Cir. 1991). The *Olson* model is based, in part, on the opinions in *In re* Bentley, 916 F.2d 431, 432 (8th Cir. 1990) (holding tax on gain of sale not abrogated by abandonment of property), and *In re* McGowan, 95 B.R. 104, 106 (Bankr. N.D. Iowa 1988) (holding estate is divested of control over, and title to, estate property when such property is abandoned).

199. 133 B.R. 264 (Bankr. D. Mass. 1991).

200. *Olson*, 930 F.2d at 7. The debtors did not object to the proposed abandonment. *Id.*

201. *Id.* at 8.

202. *See* 11 U.S.C. § 101(54) (1993) (defining "transfer" broadly).

203. Samore v. Olson (*In re* Olson), 100 B.R. 458, 462 (Bankr. N.D. Iowa 1989), *aff'd*, 930 F.2d 6 (8th Cir. 1991).

ing in *Yarbro v. Commissioner*,[204] which would equate bankruptcy abandonment with tax or property abandonment.[205]

In *Yarbro*, the taxpayer abandoned property under principles of tax and property law. Pursuant to those principles, applicable nonbankruptcy law abandonment operates as a sale or exchange and is effective in relinquishing title in the property.[206] The *Yarbro* court suggested that the finding of an exchange requires a giving, a receipt, and a nexus between the two.[207] The bankruptcy court in *Olson* found that the bankruptcy abandonment did not transfer title, did not relinquish title in the debtors, and did not result in a "receipt" required for an exchange.[208]

The Eighth Circuit affirmed. In holding that no taxable event occurred when the trustee abandoned the property, the Eighth Circuit said that it could see no reason why abandonment during the administration of the case should have different tax consequences from abandonment of property at the close of the bankruptcy case, which is not a taxable event pursuant to IRC section 1398(f)(2).[209]

The court commented that *In re Bently*[210] involved a separate, but related issue of the bankruptcy estate's liability for tax on gain from the sale of "non-abandoned property of the estate." The taxable event in *Bently* that triggered a tax liability chargeable to the estate was the sale of the property. However, title to property abandoned by the trustee reverts to the debtor as though it never had been property of the estate, and a subsequent sale of abandoned property is not a taxable event for which the bankruptcy estate can be held liable. In *Olson*, the sale of the debtors' property occurred after the trustee abandoned the property. Therefore, the Eighth Circuit concluded that abandonment is not a taxable event that triggered a tax liability of the estate. The court also concluded that property abandoned by the trustee reverts to the debtor and is treated as though the property never had been property of the estate.[211]

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204. 737 F.2d 479 (5th Cir. 1984), *cert. denied*, 469 U.S. 1189 (1985).

205. *Olson*, 100 B.R. at 462.

206. *Yarbo*, 737 F.2d at 483-84.

207. *Id.*

208. *Olson*, 100 B.R. at 462-63.

209. *In re* Olson, 930 F.2d 6, 8 (8th Cir. 1991). This was a point the bankruptcy court also asserted in justifying its holding. *Olson*, 100 B.R. at 463.

210. 916 F.2d 431 (8th Cir. 1990). In *Bently*, the Eighth Circuit held that the postpetition sale of corn by a chapter 7 trustee was a taxable event for which the bankruptcy estate is liable. *Id.* at 433. In that case, the chapter 7 trustee sold the debtor's corn crop and thereafter retained the sale proceeds for approximately 30 months before abandoning the proceeds to a secured creditor. *Id.* at 431-32. The Service then asserted a tax claim against the debtor's estate upon the grounds that the proceeds and profits from the sale of the corn constituted property of the estate pursuant to 11 U.S.C. § 541(a)(6) and pursuant to IRC § 1398(e)(1) which provides that the gross income of the debtor's estate includes the gross income of the debtor to which the estate is entitled under the BC. *Id.*

211. *Olson*, 930 F.2d at 8. It appears the *Olson* court used both legal fictions regarding bankruptcy abandonment. *Id.* Many other cases have held that abandonment in bankruptcy is not a taxable event. *See* Mason v. Commissioner, 646 F.2d 1309 (9th Cir. 1980) (holding where

The Service's position is consistent with *Olson* and its progeny. In a private letter ruling, the Service stated that abandonment during a bankruptcy case has no tax consequences to the estate because "termination of the estate" as it appears in IRC section 1398(f)(2) includes termination of the estate's interest in property as a result of abandonment or exemption.[212]

Recently, the Service issued proposed regulations under IRC section 1398, which provide that a bankruptcy estate's transfer of an interest in a passive activity loss or credit or an at risk activity loss or credit under IRC section 465 to the debtor through abandonment under BC section 554 is a nontaxable transfer.[213] In support of the proposed regulations, the Service cited *Olson*.

The better argument against taxable abandonment centers on the precise workings of IRC section 1398. A debtor can facilitate foreclosure or tender a deed in lieu of property where the adjusted basis is substantially lower than the debt *before* filing a bankruptcy petition. In such a case, the taxable event occurs prepetition and the resulting tax liability can then be transferred to the estate if a short tax year is elected by the debtor under IRC section 1398(d)(2) or if the taxable year ends before the petition is filed.[214] The short-year election converts the debtor's tax liability to a liability of the estate. This tax claim is a BC section 507(a)(7) priority claim that will be satisfied before any unsecured creditors are paid, but well after administrative expense claims and most other priority claims are paid in full. Moreover, part of the tax liability may be absorbed by net-operating loss carryovers and other tax attributes transferred to the estate pursuant to IRC section 1398(g). Of course, any unpaid balance is nondischargeable.[215] Therein lies the rub from a debtor's perspective. Congress envisioned IRC section 1398 as a means by which a debtor can shift some, but not necessarily all, of his or her current year tax liability to the estate at a priority level below most priority

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court has permitted trustee to abandon property, title revests to bankrupt, and bankrupt treated as having owned it continuously); *In re* Nevin, 135 B.R. 652, 653-54 (Bankr. D. Haw. 1991) (bankruptcy trustee required to abandon asset, returning asset and accompanying tax liability to debtors); *In re* Burpo, 148 B.R. 918, 919-20 (Bankr. W.D. Mo. 1993) (holding bankruptcy trustee's abandonment of property returns property to debtor without being taxed); *In re* Cruseturner, 8 B.R. 581, 591 (Bankr. D. Utah 1981) (holding when bankruptcy trustee abandons property, property stands as if no bankruptcy had been filed); *see also In re* Ayers, 137 B.R. 397, 400-01 (Bankr. D. Mont. 1992) (following *Olson* rule that abandonment of bankruptcy estate property is not taxable sale or exchange of property).

212. *See* Priv. Ltr. Rul. 90-17075 (Jan. 31, 1990) (ruling bankrupt estate does not incur tax liability when property is abandoned). The Service reaffirmed its position in a subsequent letter ruling and recent proposed regulations. *See* Priv. Ltr. Rul. 92-45023 (Aug. 7, 1992) (ruling abandonment of asset by bankrupt's estate is not sale or other disposition of property); Prop. Treas. Regs. §§ 1.1398-1 to -2, 57 Fed. Reg. 53,300 (1992) (same).

213. Prop. Treas. Regs. §§ 1.1398-1 to -2, 57 Fed. Reg. 53,300 (1992).

214. *See Section 1398 Regulations*, DISTRESSED BUS. & REAL EST. 9, 11-12 (1993) (recommending these strategies for debtor to transfer tax liability to estate). *See generally* I.R.C. § 1398(d)(2) (defining debtor's election to terminate debtor's taxable year when bankruptcy proceedings begin).

215. *See* 11 U.S.C. § 523(a)(1)(A) (1993) (providing for nondischargeability of tax claims).

claims but above the claims of unsecured creditors. The price a debtor must pay to use IRC section 1398(d)(2), however, is his or her potential personal liability for any deficiency as a nondischargeable claim.

There are several persuasive reasons against taxable abandonment. First, abandonment is a disclaimer of interest by the estate—a release of the trustee's judicial lien—so title and/or possession remain continuously in the debtor. Thus, the abandonment does not result in a sale, exchange, or other disposition from the estate to the debtor. This reason alone is sufficient to show that abandonment is not a taxable event.

Second, the termination of the estate's interest in property through abandonment is congruous to "termination of the estate" under IRC section 1398(f)(2). To equate "termination" under IRC section 1398(f)(2) with "closing the case" under BC section 350 is improper. Although closing a case is a form of termination, it does not exhaust all forms of termination. After all, if Congress sought to equate termination under IRC section 1398(f)(2) with case closings under BC section 350, it could have easily used the term "closing" in IRC section 1398(f)(2) instead of the term "termination." Congress chose not to do so even though BC section 350 predates IRC section 1398. This reason addresses the equitable argument advanced by the *Lane* court.[216]

Third, requiring foreclosure of the property while it is part of the estate results in all tax liability being treated as an administrative expense claim that will be paid not only before the unsecured creditors, but also before *all priority claims* under BC sections 507(a)(2) through (a)(7).[217] Therefore, the other administrative expense claims like attorney's fees of the debtor and trustee, the trustee's fees, bankruptcy fees, other estate taxes, and certain postpetition tort claims, may not be paid in full; they must share *pro rata* with the estate's current year's tax claim. Moreover, certain employee wage claims, pension fund claims, and consumer claims may never receive any distribution. Thus, delaying an inevitable property foreclosure by filing bankruptcy may reward a debtor at the expense of *all* his or her creditors. This result makes no sense.

Fourth, as constructed, IRC section 1398 provides a mechanism by which a debtor may shift at least part of any tax liability to the estate by allowing the taxable event to occur before filing the bankruptcy petition and electing to terminate the taxable year.[218] Thus, the symmetry of IRC section 1398 between liability and attributes may be preserved and settlements between a debtor and creditor before a bankruptcy filing encouraged.

Fifth, abandonment is not tantamount to foreclosure. Most often, the automatic stay will prevent the foreclosure at least until the creditor obtains relief from the stay. Meanwhile, the debtor could attempt to settle the matter to minimize the tax consequences.

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216. *See infra* Part IV.C.

217. *See* SHEPARD, *supra* note 60, at 88 (noting taxes incurred during estate administration are first priority expenses).

218. I.R.C. § 1398(d)(2).

Sixth, if there are insufficient assets in the estate to pay the tax liability, it will never be paid. The debtor does not owe the tax.[219] This result is inconsistent with the "tax favoritism" provided to an individual debtor under IRC section 1398.

Seventh, it would appear that because abandonment is treated as a taxable event, the basis of the property might be "stepped up" to its fair market value on abandonment and the debtor may receive a new holding period.[220] This may result in a windfall to the debtor, especially where the foreclosure never occurs.[221] Congress could not have intended such a result.

Finally, although important, a debtor's fresh start is not absolute. In fact, under the BC it is a rebuttable presumption.[222] Congress has subordinated a debtor's fresh start to several tax claims, including current year's taxes and taxes for taxable years ending within three years of commencement of the case.[223]

C. Lane *Model*

The case that supports the proposition that the estate should shoulder the tax consequences associated with the abandonment and subsequent foreclosure of property is *In re A.J. Lane & Co.*[224] *Lane* stands in stark contrast to *Olson*. In *Lane*, the court denied the chapter 11 trustee's motion to abandon property of the estate essentially because the debtor's tax liability would impair the debtor's fresh start. There, pursuant to BC section 554, the trustee sought to abandon two properties and a partnership interest in a partnership that owned a third property.[225] The debtor objected, arguing that the substantive grounds under BC section 554 for abandonment were not met and that the abandonment "would shift foreclosure tax consequences from the bankruptcy estate to the debtor and would destroy the debtor's opportunity for a fresh start."[226] Clearly, the trustee's sole reason for abandoning the property was to avoid the substantial income tax liability upon foreclosure on property that was of inconsequential value to the estate and burdensome to administer.[227] The facts show that the estate would have incurred a tax liability of about $3,270,000 on all the properties after using available loss

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219. *Id.*

220. For a general discussion of this and other related issues, see COOK ET AL., *supra* note 47, § 8.08.

221. *Id.*

222. *See* 11 U.S.C. § 727(a) (1993) (outlining circumstances under which court may not grant debtor discharge).

223. *See* 11 U.S.C. § 507(a)(7) (1993) (outlining taxes which take priority over other debts); 11 U.S.C. § 523(a)(1)(A) (1993) (providing for nondischargeability of § 507(a)(7) tax claims).

224. 133 B.R. 264 (Bankr. D. Mass. 1991).

225. *Id.* at 266. The motion was amended to exclude two of the properties that were subsequently refinanced. *Id.* at 266-67.

226. *Id.* at 266.

227. *Id.*

carryovers.[228] The debtor's tax liability would have been about $13,000,000. The debtor probably would not have been able to reduce taxable income by loss carryovers because those tax attributes were transferred to the estate pursuant to IRC section 1398(g) and would not be transferred back to the debtor, if at all, until the estate terminated.[229]

The *Lane* court gave three reasons for denying the trustee's motion to abandon the property.[230] First, because the facts suggested that foreclosure on the property was imminent, the *Court Holding* doctrine[231] persuaded the court to view the abandonment as a transfer from the estate directly to the secured lender with the debtor acting as a mere conduit. Second, the court held that abandonment itself is a taxable event, and that to shift the tax consequences to the debtor would destroy the symmetry of IRC section 1398 that intends to link a tax liability with its tax attributes. Third, the court held that to allow a trustee to abandon overencumbered, low-basis property would severely throttle the fresh start policy of the BC.[232] Each rationale for the *Lane* court's holding is addressed in turn.

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228. *See generally* Craig W. Friedrich, *Workouts*, 20 J. REAL EST. TAX. 94-95 (Fall 1992) (discussing *Lane*'s impact on abandonment tax consequences).

229. *See* I.R.C. § 1398(i) (allowing return of tax attributes to debtor upon termination of estate). Thus, the substantial difference between the debtor's and the estate's tax liability is a $10,000,000 swing.

230. Aside from the reasons discussed in the text of the article, the *Lane* court also questioned the merits of the abandonment. Although there existed no equity in the properties, the court observed there, nevertheless, might be value in the properties for the estate. The court based this observation on two points. First, the court suggested that BC § 506(a), which defines a secured claim, applies and made it more likely than not that value existed for the estate. Second, the court suggested that a trustee could use the cramdown provisions in chapter 11, *see* 11 U.S.C. § 1129(b) (1993) (providing for plan confirmation where plan does not discriminate unfairly and provide fair and equitable treatment despite plan's failure to comply with § 1129(a)(8)), to retain the property for the benefit of the unsecured creditors. *Lane*, 133 B.R. at 269. Aside from the time-honored rule that vests broad discretion in a trustee in deciding to abandon property under BC § 554, the *Lane* court's observations make no sense. The secured creditors were seeking foreclosure. Section 506(a) would not help, especially where the property is not appreciating. *See, e.g.*, Dewsnup v. Timm, 112 S. Ct. 773 (1992) (holding bifurcation provisions of § 506(a) and lien-voiding provisions of § 506(d) do not permit a real estate lien to be "stripped down" where debtor has abandoned property). *See generally* Mary Josephine Newborn, *Undersecured Creditors in Bankruptcy: Dewsnup, Nobleman, and the Decline of Priority*, 25 ARIZ. ST. L.J. 547, 558-72 (1993) (discussing effects of *Dewsnup* on undersecured creditors). The secured claims completely enveloped the value of the properties. Finally, cramdown is not a panacea; it is also a lot easier to threaten than it is to successfully invoke under BC § 1129(b). *See generally* Kenneth Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 133, 133-46, 171 (1979) (addressing complexities and uncertainties of cramdown rules). Thus, the value the *Lane* court was alluding to was whimsical at best.

231. *See* Commissioner v. Court Holding Co., 324 U.S. 331 (1945) (holding substance of transaction viewed as whole is controlling for tax purposes). In *Court Holding*, the Supreme Court articulated the "step-transaction" doctrine which requires collapsing each separate step in the transaction into one transaction, thereby ensuring that the substance of the transaction controls over its form. *Id.* at 334.

232. *Lane*, 133 B.R. at 274; *see also In re* Rubin, 154 B.R. 897, 899 (Bankr. D. Md. 1992) (adopting *Lane* analysis because of "overriding fresh start" bankruptcy policy).

The court's application of the *Court Holding* doctrine is unpersuasive even on the particular facts in *Lane*.[233] In essence, the court concluded that the estate would abandon directly to the creditor with the debtor being a conduit. Foreclosure, however, does not necessarily follow abandonment. In fact, most often a creditor could not have foreclosed until it obtained relief from the stay under BC section 362(d). Furthermore, operation of the stay as well as any applicable statutory periods under state law would have permitted a now more motivated debtor to workout the situation with the creditor.[234] Finally, Professor Jim Shepard cleverly and convincingly dispatches with the *Lane* court's reliance on the *Court Holding* doctrine. Professor Shepard shows that the *Lane* court in fact extracted the abandonment from the "complete" transaction.[235] According to Shepard, the beginning point in viewing the *Court Holding* doctrine should include the point at which the debtor decided to seek relief under the BC. Thus, bankruptcy relief is but one step through which the property passed from the debtor to his or her creditors.[236] In other words, where we begin the step-transaction analysis under the *Court Holding* doctrine is not as self-evident as the *Lane* court appears to suggest.

The second reason the *Lane* court offered is that abandonment itself was a taxable event, a position inconsistent with all prior authority.[237] Clearly, a foreclosure or a deed in lieu of foreclosure is a taxable event.[238] But is abandonment a taxable event? I think not. As suggested here, if a debtor's interest has always remained in the property, albeit subordinated to the estate's interest until abandonment, there can be no sale, exchange, or disposition from the estate to the debtor upon abandonment because the debtor always owned the property. Moreover, a basic tenet of tax law is that form does control sometimes.[239] If bankruptcy law treats abandoned property as

233. The *Court Holding* doctrine is always a facts and circumstances test. *See* Grossberg, *supra* note 190, at 12-8 (noting problems in applying *Court Holding* doctrine to specific facts).

234. *Id.*

235. SHEPARD, *supra* note 60, at 72-73.

236. *Id.* at 73. The *Lane* court's reliance on the *Court Holding* doctrine denies the essential factual foundation of *Court Holding*. In *Court Holding*, the Supreme Court characterized the transaction there as an attempt to evade taxes through the negotiations between the parties. 324 U.S. at 333. There a corporation was attempting to transfer property already the subject of a sales transaction to another party for the sole purpose of having the other taxed on the sale. SHEPARD, *supra* note 60, at 73. In the abandonment context there is no attempt to evade taxes, but merely an attempt to shift liability from the debtor to the estate.

237. *See, e.g.*, *In re* Olson, 930 F.2d 6, 8 (8th Cir. 1991) (holding that abandonment of property by bankrupt estate is not taxable event because it is neither "sale" nor "exchange"); *In re* McGowan, 95 B.R. 104, 108 (Bankr. N.D. Iowa 1988) (holding that abandonment of bankruptcy estate property is not "sale" or "exchange" triggering tax liability to estate).

238. *See* Helvering v. Hammel, 311 U.S. 504, 510 (1941) (holding foreclosure of mortgage with recourse was event which established "loss" of capital asset for tax purposes); Helvering v. Nebraska Bridge Supply & Lumber Co., 115 F.2d 288 (8th Cir. 1940), *rev'd per curiam*, 312 U.S. 666 (1941) (holding state's taxing of real property for nonpayment of taxes established "loss" for tax purposes).

239. For a recent case recognizing this tenet, see Richard Hansen Land, Inc. v. Commissioner, 65 T.C.M. (CCH) 2869, 2874 (1993) (stating that "[t]he question in this case is not one of

if it had never been property of the estate, tax law should acquiesce. If abandoned property is not property of the estate, abandonment cannot be a taxable event.[240]

To justify the conclusion that abandonment is a taxable event, the *Lane* court reviewed IRC section 1398(f)(2). Section 1398(f)(2) provides that the transfer back to a debtor from the estate is not a disposition when the transfer occurs with the termination of the estate, unless by sale or exchange. The *Lane* court held that the abandonment was not tantamount to the termination of the estate as required by IRC section 1398(f)(2) and must, therefore, be a taxable event.[241] This justification was expressly rejected by the court in *In re McGowan*,[242] which held that "termination of the estate" for purposes of IRC section 1398(f)(2) included termination of the estate's interest in property under BC section 554(a).[243]

The confusion over whether abandonment is a taxable event is created by using the word "terminate" in IRC section 1398(f)(2). Does "terminate" mean the case is closed under BC section 350? The Service has taken such a position, I believe unjustifiably.[244] Exactly when the estate terminates for IRC section 1398 purposes remains unclear. For example, in a chapter 11 case, confirmation of the plan and post-confirmation operation even for a number of years is not congruous to closing the case under BC section 350. Thus, something less than a BC section 350 "closing" should satisfy the termination requirement under IRC section 1398(f)(2). Therefore, the better argument is that once the estate's interest in the property terminates through abandonment, it terminates for IRC section 1398(f)(2) purposes as to the property abandoned.[245]

The *Lane* court embraced a "strict" interpretation of IRC section 1398(f)(2) in concluding that abandonment is a "sale or exchange" for tax purposes. This argument, however, proves too much. IRC section 1398(f)(1), which governs the transfer of assets and liabilities from the debtor to the estate upon filing the bankruptcy petition, makes the transfer a nonrecognition event unless it is by "sale or exchange." According to the *Lane*

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purpose but whether the acquisitions of the estates . . . 'were in fact what they appear to be in form'"). *But see* Friedrich, *supra* note 228, at 96 n.21 (noting general tax law tenent is that substance over form controls).

240. *See* Shepard, *supra* note 60, at 76 (noting abandonment should follow established property tax principles).

241. *In re* A.J. Lane & Co., 133 B.R. 264, 272-73 (Bankr. D. Mass. 1991).

242. 95 B.R 104 (Bankr. N.D. Iowa 1988).

243. *Id.* at 108.

244. *See* Shepard, *supra* note 60, at 66-67 (citing Service letter for that proposition). Professor Shepard notes that this position is inconsistent with *In re* Sonner, 53 B.R. 859 (Bankr. E.D. Va. 1985) (holding that, for tax purposes, chapter 11 case terminates when plan is confirmed). Shepard defines termination by reference to probate estate and partnership terminations. Shepard, *supra* note 60, at 66-67.

245. *See In re* Olson, 930 F.2d 6, 8 (8th Cir. 1991) (noting although trustee is relieved of administering unprofitable asset under BC when abandoned, this is not kind of benefit required for "sale or exchange" under IRC).

court, if the transfer—if one even exists—from the estate to the debtor pursuant to abandonment under BC section 554 is a "sale or exchange," then the transfer from the debtor to the estate also would be a "sale or exchange," taking that transfer out of nonrecognition status under IRC section 1398(f)(1). Thus, the transfer by a debtor to the estate becomes a realization event. Reliance on *Lane* and the *Court Holding* doctrine suggests such an analysis.[246] Of course, this analysis eviscerates the essential purpose behind IRC section 1398.

In suggesting that bankruptcy abandonment is a taxable event, the *Lane* court also relied on *Yarbro v. Commissioner*[247] and similar tax court decisions. In *Yarbro*, the Fifth Circuit characterized abandonment under tax law as a sale or exchange, and, thus, a taxable event. In a situation where an abandonment under applicable nonbankruptcy law of overencumbered property has occurred, a taxpayer receives a taxable benefit in the amount of the secured debt discharged.[248] Therefore, applicable nonbankruptcy abandonment becomes an event no different in tax significance from a foreclosure sale or deed in lieu. Asserting that a trustee conveyed property and received a benefit in the form of relief from the secured debt, the *Lane* court regarded the reasoning in *Yarbro* as "inescapable."[249]

The *Lane* court erred in attempting to equate tax abandonment with bankruptcy abandonment. The concept of abandonment for general tax purposes borrows heavily from the common law of property. In contrast, bankruptcy abandonment is a creature of statute; it has a specific meaning in bankruptcy law. Bankruptcy abandonment is a disclaimer by the estate of any interest in a specific asset of the debtor. Thus, the debtor's interest in the property remains undisturbed. To attempt artificially to weld the two distinct concepts of abandonment together would deny a rich and vibrant history associated with bankruptcy abandonment and the peculiar nature and purpose of this statutory beast.

A corollary to the second justification for treating abandonment as a taxable event relied on by the *Lane* court is that to allow the trustee to abandon the property would destroy the symmetry between IRC sections 1398(f)(2) and 1398(i).[250] This point is the most persuasive offered by the court. Section 1398(f)(2) provides that the transfer of property (other than by sale or exchange) from the estate to the debtor upon termination of the estate is not a taxable event. Section 1398(i) provides that the debtor succeeds to the estate's tax attributes on termination of the estate. By allowing the trustee to abandon property, the estate may shift the associated tax liability to the debtor while retaining the enumerated tax attributes that could have been used by the debtor to offset the amount realized from the subse-

246. *See* Wallace, *supra* note 187, at 29-30 (noting this argument, but suggesting that *Olson* and other contrary opinions have significant flaws).

247. 737 F.2d 479 (5th Cir.), *cert. denied*, 469 U.S. 1189 (1984).

248. *In re* A.J. Lane & Co., 133 B.R. 264, 270 (Bankr. D. Mass. 1991).

249. *Id.*

250. *Id.* at 273.

quent foreclosure. Of course, this is also the result where the property is deemed abandoned because it was not administered by the trustee.[251] Moreover, any tax attributes not used by the estate will ultimately revert back to the debtor upon termination of the estate and will be available to offset taxable income in the year of foreclosure, possibly ameliorating some of the harshness.[252] Nevertheless, fairness remains an essential element of bankruptcy and tax policy. It is not fair to allow a trustee to abandon property from the estate on the verge of foreclosure and, at the same time, retain for the estate the associated tax attributes.

One distinguished commentator seizes upon this lack of symmetry as a justification for characterizing abandonment as a taxable event.[253] Although the *Olson* model suggests this lack of symmetry, the conclusion that the symmetry between IRC sections 1398(f)(2) and 1398(i) is destroyed is not inescapable. One could persuasively argue that if abandonment is congruous to termination under IRC section 1398(f)(2), it should also be congruous to termination under IRC section 1398(i). Termination for one should be termination for the other. Thus, when property is abandoned, the tax attributes listed in IRC section 1398(g) should also remain with the property to the extent they can be reasonably traced. This is the position taken by the Service in proposed regulations concerning passive activity and at-risk losses and credits.[254] This combined reading of IRC sections 1398(f)(2) and (i) is analyzed in greater detail in Part IV.D below.

The third reason offered by the *Lane* court for treating abandonment as a taxable event is that abandonment of the property would shift the tax liability from the estate to the debtor, thus depriving the debtor of a robust fresh start. If the estate abandoned the property in our example, and the lender subsequently foreclosed the lien, then the postpetition tax would not be dischargeable. The debtor owes the tax. Nevertheless, as discussed previously, many tax claims as mandated by Congress weaken the fresh start policy. Section 523(a)(1) recognizes that the debtor's fresh start is subordinate to the Government's interest in collecting certain taxes for its operations, in particular, postpetition taxes and taxes entitled to priority under BC section 507(a).[255]

One can sense the struggle engaged in by Bankruptcy Judge Queenan in *Lane*. The $10,000,000 swing in tax liability between the estate and the

251. *See* 11 U.S.C. § 554(c) (1993) (providing that unless court orders otherwise, any property scheduled under § 521(1) not otherwise administered at time of case closing is abandoned to debtor).

252. *See* SHEPARD, *supra* note 60, at 74-75 (noting possible tax attributes transferred to debtor upon termination of estate).

253. *See* Lipton, *supra* note 51, at 14-15 (noting that if abandonment is not taxable event to estate, tax consequences will be imposed on debtor, who no longer has tax attributes that relate to ownership of asset).

254. *See* Prop. Treas. Regs. §§ 1.1398-1(d)(2) to -2(d)(2), 57 Fed. Reg. 53300-02 (1992) (proposing bankruptcy estate succeed to unused passive activity losses and credits of individual debtor in chapter 7 or 11 case).

255. SHEPARD, *supra* note 60, at 75; *In re* Hanna, 872 F.2d 829, 831 (8th Cir. 1989).

debtor forced by the superficial peculiarities of IRC sections 1398(f)(2) and 1398(i) appears to be patently unfair and produces a harsh result.[256] Bankruptcy is a never-ending contradiction between a creditor's debt-collection activity and a debtor's discharge. Based on Congress's failure to foresee the vagaries associated with midstream abandonment, Judge Queenan struck the balance in favor of the debtor by denying the proposed abandonment. Thus, in a very real sense, Judge Queenan fashioned another implied limitation on the trustee's power to abandon property under BC section 554, a limitation not found in the language of the statute itself. In that fashion, he has done nothing more than the Supreme Court did in *Midlantic*.[257] In fact, there are several similarities between the two opinions.[258] First, both the fresh start policy limitation in *Lane* and the environmental policy limitation in *Midlantic* are not supported by the language of BC section 554, but are implied limitations on the power of abandonment. Second, both of these countervailing policies are of great force—the former draws its force from the BC, while the latter draws its force from state and federal environmental laws. Third, because the effect of both limitations is to force the estate to retain burdensome or income-draining assets, both limitations feed off the priority claimants and unsecured creditors of the estate, effectively forcing these creditor classes to subsidize taxing and environmental authorities while allowing a debtor to walk free from his obligations (at least in the tax context).

Lane generated more questions than it answered. If abandonment is a taxable event, what is the new basis in the property? If the lender never forecloses on the property, does the debtor receive a stepped-up basis in the property? A new holding period? If that is the case, is it not unfair? Would this not result in a windfall to the debtor? These important tax questions go unanswered in *Lane*.

The most troubling aspect of about Judge Queenan's decision in *Lane* is not its failure to address these tax issues (after all, they can and will be addressed later), but the failure to recognize the repercussions of *Lane* on its particular facts. For example, *Lane* is a chapter 11 case commenced by an individual debtor. Judge Queenan was correct when he observed that an individual's right to discharge is a compelling policy under the BC. But so is the policy of reorganization. After all, *Lane* is a chapter 11 case. Yet nowhere in the opinion does the court discuss or even mention the effect the denial of the proposed abandonment will have on the reorganizational efforts

256. Often, fairness is in the eye of the beholder. After all, many of these debtors had the use of and presumably enjoyed the money, generated income or acquired other properties, and paid down debt secured by otherwise exempt property. Additionally, these debtors received the benefit of accelerated depreciation to shelter income.

257. Midlantic Nat'l Bank v. N.J. Dept. of Envtl. Protection, 474 U.S. 494 (1986). See *supra* Part III.C and accompanying notes for a discussion of limitations on the power of abandonment.

258. These similarities were not lost by one commentator. *See* NEWTON & BLOOM, *supra* note 41, § 4.11(a)(i), at 121 (comparing *Midlantic* to situations found by bankruptcy trustees who have recovered estate property, sale of which creates greater tax burden than amount received by estate).

of the estate. *Lane* is no dog real estate case. The chapter 11 trustee had already come to terms with lenders on two of the properties. But the court transformed the reorganizational landscape by ordaining a tax claim that would not have been a legitimate claim against the estate into a $3,000,000 administrative expense claim. Because this claim must be paid in full before most of the BC section 507(a) priority claims and all of the unsecured claims, and within the strict timing requirements on such payments under BC section 1129, the *Lane* decision must have had an onerous impact on the feasibility and ultimate confirmability of any chapter 11 plan.[259] Unfortunately, we are left with troubling questions and no hint of an answer.

D. *Tax Attribute Model*

A variation of the *Lane* model addresses the potent argument that it is patently unfair to allow a trustee to avoid the tax consequences of the immediate foreclosure of the property through abandonment and, simultaneously, to retain the tax attributes associated with the property to shield income of the estate. Thus, abandonment destroys the calculated symmetry between IRC sections 1398(f)(2) and 1398(i). This unfair result may be dictated by the *Olson* model. But, as noted above, such a result is not necessarily dictated by IRC sections 1398(f)(2) and 1398(i). For example, if midstream abandonment is a termination for IRC section 1398(f)(2) purposes, it should similarly equate to a termination for IRC section 1398(i) purposes. This construction of IRC section 1398 avoids the symmetry problem generated in *Olson* and similar cases.

The Service has recently taken the position that as to those attributes it adds to IRC section 1398(g) by regulation, it would be unfair to saddle a debtor with tax liability upon abandonment and subsequent foreclosure while allowing the estate to retain the tax attributes associated with the property. Accordingly, if the estate transfers an interest in a passive activity, former passive activity, or an unused IRC section 465 loss from an abandoned activity by midstream abandonment before the termination of the estate (as defined by the Service), then:

> (1) the estate must allocate to the transferred interest part or all of the estate's unused passive activity loss and unused passive activity credit, determined as of the first day of the estate's tax year in which the transfer occurs, and (2) the debtor succeeds to and takes into account, beginning with the debtor's tax year in which the transfer occurs, the unused passive activity loss and unused passive activity credit allocated to the transferred interest.[260]

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259. As a condition for confirmation of a chapter 11 plan, all tax claims that constitute administrative expenses under § 507(a)(1) must be paid in full in cash on the effective date of the plan. 11 U.S.C. § 1129(a)(9) (1988). In contrast, tax claims that constitute priority claims under § 507(a)(7) may be paid in deferred cash payments over six years from the date of assessment of the tax claim. *Id.*

260. Lipton, *supra* note 51, at 15.

The Service has gone far to recognize the harm to a debtor caused by the lack of symmetry posed by the *Olson* model. The new proposed regulations ameliorate some of that harm. However, as Richard Lipton cogently observes, the proposed regulations do not go far enough.[261] The regulations do not cover the other IRC section 1398(g) tax attributes such as net operating loss carryovers and credits that relate to the abandoned property.[262] Thus, under the *Olson* model, these other tax attributes remain with the estate. Lipton surmises that the Service may not have provided (if it had the authority to do so in the first place) that remaining IRC section 1398(g) attributes follow the abandoned property because the Service was concerned that no specific rules exist for the allocation of net operating losses and credits to the various assets of a debtor.[263]

The symmetry problem may be overstated. The mandatory adjustment of tax attributes at the end of the taxable year in which the discharge is entered effectively deprives the estate of the use and benefit of any attributes.[264] Thus, symmetry may be an illusion in the first place. Additionally, a flaw in the symmetry argument is that the argument is premised on the assumption that any tax attributes generated with regard to the property proposed to be abandoned actually exist at the time the debtor filed for relief under the BC. First, the debtor may have used these attributes by means of an IRC section 1398 election. Second, many debtors may have already used these attributes to shelter prepetition income; therefore, the attributes may never have been available to the estate in any event.[265]

I believe *Lane* may have been on safer ground if it had articulated this model of the tax effects of abandonment. There is a fairness question posed by the *Olson* model. Nonetheless, as a normative principle, I do not believe the tax attribute model goes far enough to protect the debtor's and creditors' interests.

E. ABA Model

In 1993, the Section 108 Real Estate and Partnership Task Force ("Task Force") of the Section of Taxation of the American Bar Association published a report on the tax consequences posed by bankruptcy abandonment before the close of the case.[266] After noting judicial disagreement on the subject, the Task Force proceeded to disagree among itself. The majority camp embraced *Lane* as its working model, while the minority camp endorsed *Olson* as its working model.

261. *Id.*

262. *Id.*

263. *Id.* at 16.

264. *See* I.R.C. § 108(b)(2).

265. I want to thank Professor Jim Shepard for bringing home this point to me.

266. *Report of the Section 108 Real Estate and Partnership Task Force (Part I)*, 46 TAX LAW. 209 (Fred Witt ed., 1992); *Report of the Section 108 Real Estate and Partnership Task Force (Part II)*, 46 TAX LAW. 397 (Fred Witt ed., 1993) [hereinafter *Task Force Report*].

The consensus of the Task Force is "that an abandonment constitutes a taxable disposition to the bankruptcy estate,"[267] based on IRC section 1398 and the fresh start policy in bankruptcy.[268] Although these two justifications may fuel the conclusions reached, they are too thin a wedge to support the model explicated by the Task Force.

Although the BTA "attempted to provide a comprehensive statutory scheme regarding the tax consequences of the bankruptcy provisions," the Task Force recognized that the tax consequences posed by abandonment were completely overlooked.[269] Much of the justification for the Task Force's conclusion rests on two related points. First, the Task Force believed that because the estate and the debtor are separate taxable entities, abandonment as a transfer of the property would constitute a taxable disposition.[270] Second, the Task Force reasoned that under the principles of *Yarbro v. Commissioner*,[271] a tax abandonment is a sale or exchange for tax purposes, and, thus, bankruptcy abandonment should also be a sale or exchange for tax purposes.[272]

Unfortunately, the Task Force mischaracterized the nature of bankruptcy abandonment and fell victim to the siren song that seeks to equate all types of abandonment. Because a bankruptcy abandonment is a disclaimer by the trustee of the estate's interest in the property, the fact that the estate and the debtor are separate tax entities is really irrelevant. There is *no* transfer that constitutes a "sale or exchange" for IRC section 1001(c) purposes. The debtor's interest always remained in the abandoned asset; resort to the relation back doctrine or other fictions is thus unwarranted. Furthermore, as discussed earlier, *Yarbro* dealt with property and tax law abandonment, not bankruptcy abandonment. Although it may be natural to equate the concepts, it is incorrect to do so. The various concepts of abandonment are creatures of their contexts, drawing life from the specific policies at play in their own corners of the legal galaxy. I believe the Task Force shows the weakness of its position when the only statement directly supporting the application of *Yarbro* in equating tax law and bankruptcy abandonment is that "the *Yarbro* analysis is equally applicable to abandonments in bankruptcy."[273] Contrary to the manner in which the proposition is stated, it is far from self-evident.

F. National Bankruptcy Conference Model

Recently, the National Bankruptcy Conference ("Conference") discussed the issues posed by bankruptcy abandonment as part of its Bankruptcy Code Review Project. The Conference recommended that the IRC be amended to provide that gain "realized from the sale, exemption, *abandon-*

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267. *Task Force Report*, *supra* note 266, at 449.
268. *Id.*
269. *Id.*
270. *Id.*
271. 737 F.2d 479 (5th Cir. 1984), *cert. denied*, 469 U.S. 1189 (1985).
272. *Task Force Report*, *supra* note 266, at 450.
273. *Task Force Report*, *supra* note 266, at 449 (citation omitted).

ment, foreclosure, or other disposition of assets that occurs during an individual chapter 7 or 11 case should be treated as discharge of indebtedness income."[274]

In reaching its recommendation, the Conference recognized what drives the present controversy—the disparate treatment by the IRC between cancellation of indebtedness income under IRC section 108 and gain realized upon foreclosure under IRC section 1001(c). Under IRC section 108, cancellation of indebtedness income that would otherwise be includable in gross income under IRC section 61(a)(12) is excludable to the extent the taxpayer is insolvent or the discharge occurs pursuant to a court order in bankruptcy.[275] However, the IRC extracts a price for the IRC section 108 exclusion—certain enumerated tax attributes must be reduced by the directives of section 108(b). If there are no tax attributes or the attributes have been used up, any remaining cancellation of indebtedness income evaporates in bankruptcy; the taxpayer is no longer liable for the tax associated with the income. This is an important tax break for bankrupt or insolvent taxpayers which is not provided for other taxpayers.

This tax favoritism does not exist for amounts realized under IRC section 1001(c) upon a sale or exchange such as a foreclosure. The IRC section 108 exclusion applies *only* to cancellation of indebtedness income; the exclusion does not apply to reduce tax liability associated with gain realized from high-debt, low-basis property.[276]

What exacerbates the situation, however, is how nonrecourse debt is treated upon foreclosure.[277] If the secured debt is recourse, the Service has maintained the position that the full tax consequences take two steps to ascertain.[278] First, the amount of cancellation of indebtedness income is equal to the difference between the fair market value of the property and the amount of the recourse debt.[279] This amount may be excluded in bankruptcy under IRC section 108. Second, the amount realized for IRC section 1001(c) purposes is equal to the difference between the asset's fair market value and

274. National Bankruptcy Conference, *Bankruptcy Reform Circa* 1993 (June 10-12, 1993) [hereinafter NBC Report] (emphasis added).

275. I.R.C. § 108(a) (1988); *see also* NEWTON & BLOOM *supra* note 41, §§ 2.1-2.16 (analyzing IRC § 108 as it applies to discharge of indebtedness income in bankruptcy proceedings). Two other conditions that permit a taxpayer to exclude cancellation of indebtedness income from gross income are qualified farm indebtedness and qualified real estate indebtedness. I.R.C. § 108(a)(i)(C)-(D) (1988).

276. I.R.C. § 108(a).

277. For a detailed treatment of the tax consequences of foreclosure, see Mary Cunningham, *Payment of Debt with Property—The Two Step Analysis After* Commissioner v. Tufts, 38 TAX LAW. 575, 599-605 (1985); Richard C. Onsager & John R. Becker, *The Federal Income Tax Consequences of Foreclosures and Repossessions*, 18 J. REAL ESTATE TAX. 291 (1991).

278. *See generally* Onsager, *supra* note 63, at 103 (discussing tax consequences that arise in connection with postpetition sale of property subject to recourse debt as bifurcated process).

279. *See* Treas. Reg. § 1.1001-2(c) (1993) (providing example tax calculations on amount realized on sale or disposition of property securing recourse debt); Rev. Rul. 90-16, 1990-1 C.B. 12 (holding taxpayer realizes income from discharge of indebtedness to extent amount of debt exceeds fair market value of property).

its adjusted basis.[280] This IRC section 1001(c) amount is not governed by the more generous rules of exclusion in IRC section 108. The consequence of this two-step method asserted by the Service often is that the parties who are in informal workouts or who have agreed to terminate the automatic stay in bankruptcy agree to a value for the underlying asset on the extreme low end of the range of fair market values to minimize gain and to maximize cancellation of indebtedness income.

If the secured debt is nonrecourse, the Supreme Court mandates significantly different treatment. If the secured debt is nonrecourse, the amount realized for IRC section 1001(c) purposes is equal to the difference between the face amount of the debt and the adjusted basis in the asset.[281] The fair market value of the property is irrelevant to the calculation. This creates greater hardship when the assets in question have substantially declined in value, as was the experience in the real estate markets in the Southwest. Furthermore, no cancellation of indebtedness income is generated by the full satisfaction of nonrecourse debt by foreclosure; thus, a taxpayer cannot use IRC section 108 to alleviate any tax associated with the foreclosure sale and ultimate discharge of nonrecourse debt. This peculiar result has led some taxpayers to attempt to convert nonrecourse debt for which they are not personally liable, to recourse debt for which they are personally liable in an attempt to use IRC section 108 to minimize taxes owed from the contemplated foreclosure.[282]

An example may illuminate the disparate treatment of nonrecourse debt *viz a viz* recourse debt. In the previous example in Part IV.A, a debtor, we shall call him Tinker, owns an office building subject to nonrecourse indebtedness of $1,000,000. The fair market value of the property is $500,000, and the adjusted basis is $250,000. If the lender forecloses upon the property in full satisfaction of the debt, the amount realized under section 1001(c) is $750,000, the difference between the amount of nonrecourse debt and the adjusted basis. In other words, Tinker is treated as though he sold the property for the face amount of the debt. None of the section 1001(c) gain may be excluded under IRC section 108; section 108 is reserved for cancellation of indebtedness income.

In another example, let us assume that Chance operates a similar building on a property adjacent to Tinker's. In fact, she used the same lender and granted a lien in the property securing $1,000,000 of indebtedness. She is personally liable for the debt; that is, the debt is recourse as to Chance. The fair market value of the property and the adjusted basis are exactly the same

280. *Id.*

281. Commissioner v. Tufts, 461 U.S. 300, 310-13 (1983); Treas. Reg. § 1.1001-2; *see also* Onsager, *supra* note 63, at 103 (discussing tax treatment given nonrecourse debt in postpetition sale of property).

282. Of course, to the extent the conversion from nonrecourse to recourse is part of a sham or a tax avoidance scheme, IRC § 269 (1988) will prevent its intended effects. After all, there has been no economic change in the parties' positions. Furthermore, I believe that the Service may characterize the conversion as an "exchange" under IRC § 1001(c).

as in the Tinker example—$500,000 and $250,000, respectively. If the lender forecloses on the property in full satisfaction of the recourse debt, Chance's tax consequences are vastly different from Tinker's. Using the two-step analysis asserted by the Service, Chance recognizes cancellation of indebtedness income of $500,000, the difference between the amount of indebtedness and the fair market value of the property. The entire amount may be excluded from income pursuant to IRC section 108. Chance also recognizes income under IRC section 1001(c) of $250,000, the difference between the property's fair market value and its adjusted basis. Thus, on the same facts, Chance recognizes $500,000 *less* income than Tinker *solely* because her debt was recourse, and Tinker's debt was nonrecourse.

The Conference recognized this differential treatment of taxpayers. It observed that "[t]here seems [to be] no justifications in tax or bankruptcy policy for such quixotic results."[283] The Conference recognized that the same policies that give rise to the exclusion of income under IRC section 108 also apply to gain realized under IRC section 1001(c) when the proceeds are distributed to creditors. As a result, the Conference suggested that in a bankruptcy case under chapter 7 or 11, all income attributable to the disposition of estate property should be treated as cancellation of indebtedness income under IRC section 108, subject to exclusion and attribute reduction.[284]

This bold attempt by the Conference should be applauded. Equating the treatment of section 108 income with section 1001 gain rationalizes the bankruptcy process and provides a common sense solution to this difficult problem. One must recall that when property is surrendered to a creditor by foreclosure, neither the estate nor the debtor realizes any economic gain.[285] Thus, the Government has no legitimate claim to the tax on either type of income. To its credit, the Conference noted that the Government does have one legitimate concern, which is to ensure that the previously realized tax benefits associated with the property do not survive the bankruptcy case to exclude post-bankruptcy income.[286] The Conference's proposal addressed the Government's concern.

While the Conference's attempt to address the tax consequences posed by bankruptcy abandonment are welcomed, I believe the Conference's proposal failed to address certain issues such as whether a debtor should have to opt out of the IRC section 1398 short-year election and who bears the tax realized after the filing of a no-asset report by the chapter 7 trustee before the case is closed. Finally, the modifications to IRC section 108 suggested by the Conference appear to apply only where an individual taxpayer files a petition under chapter 7 or 11. I believe this proposal does not go far enough. Providing different treatment to bankrupt and insolvent taxpayers under IRC section 108 may increase bankruptcy filings solely for tax pur-

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283. NBC Report, *supra* note 274, at 89.

284. *Id.* at 90; *see generally* I.R.C. § 108(a)-(b) (1988) (providing for treatment of discharge of indebtedness income).

285. NBC Report, supra note 274, at 90.

286. *Id.*

poses. Furthermore, many policies advanced by the Conference apply equally well to insolvent, nonbankrupt taxpayers. Additionally, the proposed changes should not be limited to chapter 7 or 11 cases. Individuals should be able to tap into the favorable treatment under any eligible chapter of the BC.

G. *Proposed Model*

The model for the treatment of the tax consequences of abandonment proposed by this article borrows much from the various models analyzed. The model builds on the theoretical scaffolding provided by the contemporary models in an attempt to accommodate the legitimate interests of the parties in treating abandonment and subsequent foreclosure for tax purposes. It seeks to provide consistency and coherence, recognizing that the paradigmatic models fail the complete task.

The model proposed here addresses the two related questions posed by the tax consequences of abandonment—whether a tax should be imposed in the first instance and, if so, upon whom. The Conference report answers much of the first question. When property is foreclosed or otherwise surrendered to a creditor, the taxpayer (the debtor or the estate) receives no economic or psychic benefit in these circumstances. The IRC recognizes this fact when addressing cancellation of indebtedness income under IRC section 108. Generally such income is included in gross income under IRC section 61(a). Tax law provides a break to insolvent or bankrupt taxpayers by allowing them to exclude such income, subject to attribute reduction. The attribute reduction is a necessary part of this doctrine so as to accommodate the Government's concern that tax attributes associated with the estate property may be used to shelter post-bankruptcy income. Common sense dictates that the IRC recognize the same treatment for IRC section 1001(c) gain arising in similar circumstances. This result furthers the fresh start policy embodied in the statutory discharge provided to an individual debtor under the BC. At the same time, it accommodates the Government's interest in collecting the tax.

So far, the proposed model mirrors the treatment called for by the Conference report. Where the proposed model diverges from the Conference report is to expand section 108 treatment for individual debtors who file for relief under chapters 12 and 13 and for insolvent taxpayers who have not sought relief under the BC.

Although a separate taxable entity is created only where an individual files for relief under chapter 7 or 11,[287] the proposed expansion of the section 108 exclusion and attribute reduction rules for cancellation of indebtedness income and section 1001 gain should be afforded to individual debtors seeking relief under chapter 12 or 13 for several reasons. First, the fresh start policy is as strong in chapter 12 or 13 as it is in chapter 7 or 11 for individual debtors. Second, the unfairness of the tax resulting from the disposition of an asset to the creditors exists in all chapters under the BC. Third, both bank-

287. I.R.C. §§ 1398, 1399 (1988 & Supp. IV 1992).

ruptcy and tax law recognize a strong policy to minimize the influence of tax consequences in selecting under which chapter an individual debtor seeks relief. By restricting favorable section 108 treatment to chapter 7 or 11 cases, the Conference report conflicts with this policy. The situation becomes more problematic in light of statistical evidence suggesting that creditors receive a greater distribution in a chapter 13 case than in a chapter 7 case.[288] Finally, when referring to bankruptcy taxation, conventional wisdom often suggests different treatment between chapters 7 and 11, where a separate tax entity exists, and the remaining chapters under Title 11. But the separate entity rules are relevant as to who pays the tax; they do not speak about whether the tax should be imposed in the first instance.

The proposed model would also expand the applicability of the new section 108 exclusion and attribute reduction rules to insolvent taxpayers who have not filed for relief under the BC. This expansion rests on two related points. First, when enacting section 108, Congress was concerned with providing a windfall to a taxpayer due to the happenstance of bankruptcy. Thus, it enacted section 108 with the express purpose of providing a tax benefit to similarly situated taxpayers—insolvents and bankrupts. Second, to the extent that an insolvent taxpayer remains insolvent, the income generated by the foreclosure or disposition of property to a creditor provides no economic or psychic benefit. Thus, the tax associated with the property is unfair.

Section 108 addresses the Government's concern that tax attributes associated with the property not survive to shelter post-bankruptcy income. In return for permitting exclusion of income in certain circumstances, section 108 requires attribute reduction.[289] Like the Conference model, the proposed model recognizes this governmental concern.

Although the first major concern—whether a tax should be imposed in the first instance—looms in the background, bankruptcy abandonment directly conjures up the second major concern—who must pay the tax? As previously discussed, this is a concern only in individual chapter 7 or 11 cases,[290] since a separate taxable entity is created only in such cases.[291]

The Conference proposal does not directly speak to this issue. Granted, the issue is not as important in a situation with an expanded IRC section 108 where cancellation of indebtedness income and realized gain are treated similarly. Nonetheless, it can be important where, pursuant to IRC section 1398(g), the estate possesses many tax attributes, some of which may not be associated with the asset proposed to be abandoned. In this situation, the debtor's concern for a robust fresh start is not directly implicated. Furthermore, the Government's concern about the abuse of tax attributes associated

288. This statistical evidence is on file with the author.

289. *See* I.R.C. § 108(b) (1988) (mandating reduction in tax attributes equal to Title 11 discharge indebtedness).

290. *See* I.R.C. § 1398 (1988 & Supp. IV 1992) (providing that internal revenue rules relating to individual Title 11 cases apply to chapter 7 and 11 cases).

291. *See* I.R.C. § 1399 (1988) (providing commencement of Title 11 case does not result in separate taxable entity).

with the property is not directly implicated. However, the estate creditors' interests are greatly affected by the resolution of this issue. Tax attributes held by the estate associated with other properties may be used by the estate to shelter estate income, which redounds to the estate creditors' benefit.

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

Thus, under the proposed model, the determination as to who is responsible for the tax depends on when the taxable event, such as the foreclosure takes place. Like the *Olson* model, if the foreclosure occurs when the asset is estate property, the estate and not the debtor is liable for the tax. With an expanded application of the IRC section 108 exclusion and attribute reduction rules, the result may require the estate to reduce not only the attributes associated with the property, but also other delineated tax attributes.[292] If the foreclosure occurs after abandonment when the property is no longer property of the estate, then the debtor is liable for the tax, but the debtor may take advantage of the expanded IRC section 108 attribute reduction rules. To protect the Government's concern regarding the misuse of tax attributes, the proposed model provides for the transfer of the tax attributes associated with the abandoned property to the debtor. Furthermore, as to net operating losses, credits, and other IRC section 1398(g) tax attributes that are not necessarily interwoven with a particular asset, the Service should propose regulations allocating such attributes in a reasonable fashion to the abandoned assets. Thus, IRC section 1398 should be modified to provide that the debtor must reduce the tax attributes associated with the property in accordance with the expanded version of IRC section 108. As a result, the estate does not receive the windfall present under the *Olson* model by shifting the tax burden to the debtor while retaining the tax benefits associated with the abandoned property.[293]

A major deficiency in the contemporary models is their failure to address the practicalities of the overwhelming number of individual bankruptcy cases. A trustee has a duty to abandon property of inconsequential value and benefit to the estate; failure to do so *should* result in either a surcharge on the trustee's bond or personal liability of the trustee.[294] This is

292. *See id.* § 108 (mandating tax attribute reduction).

293. Recall that this windfall to the estate may be illusory. See *supra* notes 264-65 and accompanying text.

294. A conflict exists regarding when personal liability should be imposed on a bankruptcy trustee. *Compare* Yadkin Valley Bank & Trust Co. v. McGee, 819 F.2d 74, 76 (4th Cir. 1987) (holding trustee's conduct *must* be intentional); Ford Motor Credit Co. v. Weaver, 680 F.2d 451, 461-62 (6th Cir. 1982) (same) *and* Sherr v. Winkler, 552 F.2d 1367, 1375 (10th Cir. 1977) (same) *with In re* Gorski, 766 F.2d 723, 727 (2d Cir. 1985) (holding trustee *may* be held liable for negli-

especially true when the trustee fails to abandon property that results in a substantial tax to the estate.[295] Nonetheless, it is a fact that most bankruptcy filings by individuals are "no-asset" cases. In a "no-asset" case, no assets will remain for distribution to the unsecured creditors once the secured creditors receive the value of their collateral and the debtor declares his or her exemptions under BC section 522. The determination of whether the case is a no-asset case is made by the chapter 7 trustee, usually at the first meeting of creditors or soon thereafter.[296] Once the trustee decides that the bankruptcy is a no-asset case, he or she files a "no-asset report." Most often, this means that the trustee has essentially washed his or her hands of the case. This is imprudent as evidenced by the discussion below.

The filing of a no-asset report is not a deemed abandonment of property under BC section 554(c). Thus, a foreclosure that occurs after the no-asset report is filed but before the case is closed generates a tax liability that is an administrative expense of the estate; the debtor is not liable for any tax. This creates two problems. First, the Service may not collect the tax from the debtor, which it would be empowered to do under present law if an abandonment had occurred before foreclosure. Under this scenario, the Service is harmed because the estate has no assets to pay *any* claims. Its only redress is against the trustee for breach of fiduciary duties owed to estate creditors.[297] Second, it is not uncommon for no-asset cases to become asset cases. A large inheritance in certain circumstances after the case was commenced,[298] the recovery of fraudulent transfers and avoidable preferences,[299] or the identification of assets of the debtor concealed or forgotten[300] may transform a no-asset case into an asset case. Yet, if a foreclosure had occurred while an asset was property of the estate, the tax associated with the asset is a first priority administrative expense claim. This result has a direct and substantial financial impact on the estate's unsecured creditors, who must wait to participate in the newly found assets until the Government is paid in full.[301]

The short answer is that even in a no-asset case, the trustee should abandon property of inconsequential value and benefit to the estate. However, this procedure is costly. In a no-asset case, the trustee must pay the costs associated with a proposed abandonment out of his or her own pocket or fear

gent and intentional misconduct); Red Carpet Corp. v. Miller, 708 F.2d 1576, 1578 (11th Cir. 1983) (same); *In re* Cochise College Park, Inc., 703 F.2d 1339, 1359 (9th Cir. 1983) (same) *and In re* Sturm, 121 B.R. 443, 447 (Bankr. E.D. Pa. 1990) (same).

295. The Service has asserted the position that a trustee who fails to abandon such property is personally liable for the tax. Letter from District Counsel, Internal Revenue Service, Midwest Region to Anonymous Trustee (Dec. 3, 1992) (on file with author).

296. *See* 11 U.S.C. § 341 (1988) (providing for meeting of creditors).

297. *See id.* § 704 (1988) (delineating trustee's duties).

298. *See id.* § 541(a)(5) (1988) (providing property received by bequest, devise, or inheritance within 180 days after filing of petition become part of the bankrupt estate).

299. *See id.* §§ 547-548 (relating to voidable preferences and fraudulent conveyances).

300. An example of this situation is the forgotten tax refund check.

301. *See* 11 U.S.C. §§ 507, 726 (1988 & Supp. 1992) (providing priority for government tax claims).

personal liability. This result is unacceptable. The model proposed here modifies BC section 554 by providing that the filing by a chapter 7 trustee of a no-asset report constitutes a deemed abandonment of assets listed in a debtor's schedules unless the report provides otherwise. This modification more accurately reflects the intention and understanding of the parties involved.

The final dimension of the model proposed in this article deals with the mechanics of the short-year election.[302] Presently, an individual debtor must *elect* to bifurcate his or her tax year to take advantage of the tax benefits in IRC section 1398. This election must be made on or within the fifteenth day of the fourth full month from the commencement of the case.[303] Failure to make the election in a timely manner results in a waiver of the section 1398 tax benefits.

The overwhelming majority of cases benefit from the section 1398(d)(2) short-year election. Yet, many debtors fail to make a timely election because of miscalculations or incompetent counsel. Section 1398 should be modified to provide for its automatic application in all cases. A debtor should be required to *opt out* of section 1398(d)(2) short-year treatment. This modification should reduce the failure to use the benefits provided by IRC section 1398 and further the fresh start policy embodied in both the BC and IRC.

V. CONCLUSION

Greek legend tells of a bandit named Procustes who guarded a mountain pass, stopping all travelers on their way. He had a bed and would force the traveler to lie on it. If the traveler was too tall for the bed, Procustes cut off his legs; if the traveler was too short, Procustes stretched the traveler, pulling out his legs and arms until he fit. Midstream bankruptcy abandonment is a Procustean bed; each relevant BC and IRC section is like the unwary traveler in Procustes's day. None seems to fit the bed just right.

The paradigmatic models analyzed in this article generally fail the task of providing a comprehensive model for treating the tax consequences of bankruptcy abandonment. Some models fail to appreciate the distinct nature of bankruptcy abandonment. Other models pose fundamental questions of fairness regarding the imposition and assignment of the tax. Still other models generate incentives to seek bankruptcy relief solely to take advantage of certain tax breaks, gravely disrupting the time-honored tax principle of horizontal equity—treating similarly situated taxpayers equally.[304]

Presently, the debate centers on who pays the tax—the estate or the individual debtor. Although important, this question obscures a more funda-

302. *See* I.R.C. § 1398(d)(2) (1988 & Supp. IV 1992) (permitting debtor to create two taxable years).

303. *See supra* notes 75-80 and accompanying text for a discussion of the short-year election.

304. DANIEL Q. POSIN, FEDERAL INCOME TAXATION 8-24 (1983) (summarizing theoretical aspects of taxation).

mental question—whether a tax is to be imposed in the first instance. The model proposed here answers this fundamental question by resorting to the mechanism already carefully crafted in IRC section 108. By expanding the applicability of IRC section 108 to cover the IRC section 1001(c) gain generated by a transfer of property to a creditor in satisfaction of a debt, the proposed model permits exclusion of the income associated with such transfer from gross income in exchange for attribute reduction. Thus, IRC section 108 provides the basic framework, which accommodates the interests of the debtor, the creditors, and the Government. Allowing both insolvent and bankrupt taxpayers the ability to use expanded IRC section 108 will minimize the strategic use of bankruptcy for tax purposes and preserve the horizontal equity of tax law. In addition, requiring that tax attributes associated with abandoned property be transferred to the debtor along with the property ameliorates the unfairness of some models. Finally, the addition of provisions which establish that the filing of a no-asset report by a trustee constitutes a deemed abandonment and which require that an individual debtor opt out of IRC section 1398 treatment more closely aligns the law with the expectations of the parties.

The present state of the law is an unacceptable alchemy of risk taking (or aversion) and specialized knowledge. If a debtor does not want to be burdened with a realized gain tax under IRC section 1001(c), he or she may file a bankruptcy petition, hope for a neglectful or tax-ignorant trustee, and hasten asset foreclosure while such asset is estate property. If successful, the estate is liable for the tax and the debtor absolves himself or herself of tax liability. The knowledgeable trustee, however, will recognize this set-up and abandon the property before foreclosure. In that case, the debtor owes the entire tax; the tax is not an allowable claim of the estate and is nondischargeable. Fearful of this worst-case scenario, a debtor may allow foreclosure of the property on the eve of the bankruptcy filing, make a timely IRC section 1398(d)(2) election, close the short taxable year, and shift at least part of the tax liability to the bankruptcy estate as a seventh-level priority claim. However, any remaining tax is a nondischargeable claim that may significantly throttle a debtor's fresh start.

There is no justification for the perverse incentives now existing in the interface between bankruptcy and tax law. The proposed model opts for a comprehensive, uniform rule that thoroughly addresses the problems posed by the tax consequences of bankruptcy abandonment. Such problems provide us with an enlightening peek at the fundamental contradiction in bankruptcy law. On the one hand, bankruptcy is viewed as providing a collective debt-collection forum ostensibly for the estate creditors' benefit, and in their best interests. On the other hand, bankruptcy law magically conjures up the right to discharge one's debts (or reorganize one's business), a result alien to the long history of bankruptcy law and creditors' rights. To date, the system of bankruptcy has been described as a bivalent one, with strings of yes's and no's, ones and zeroes. Authorities search for the primacy of the two competing bankruptcy goals—rehabilitating debtors and protecting creditors' interests—failing or refusing to recognize not only the inherent contradiction posed by the two irreconcilable policies, but also the multivalent or fuzzy nature of bankruptcy law as a continuous system.[305] The hard truth is that there is no universal heuristic to solve the bankruptcy paradox; there are only partial truths. This is the nature of a fuzzy system. And the partial truths we cling to say more about us, the way we think, and the way we envision the world than they do about the system we attempt to describe.

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305. *See* Jack F. Williams, *Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guarantees: Fraudulent Transfer Law as a Fuzzy System*, 15 CARDOZO L. REV. 1403 (1904) (suggesting use of fuzzy logic in interpreting BC); *see also* Leif M. Clark, *Fuzzy Thinking and Legislating Logically*, XII A.B.I.J. 14 (Dec. 1994) (same); Leif M. Clark, *Some Fuzzy Thoughts*, XII A.B.I.J. 14 (Sept. 1993); Mark E. MacDonald et al., *Chapter 11 as a Dynamic Evolutionary Learning Process in a Market with Fuzzy Values*, 1993 ANN. SURV. BANKR. L. 1 (same). For a general account of fuzzy logic, see BART KOSKO, FUZZY THINKING: THE NEW SCIENCE OF FUZZY LOGIC (1993).