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THE HIDDEN TAX TRAPS IN ABANDONMENTS
— by Neil E. Harl'

Abandonments in bankruptcy have been a serious problem for debtors for several years.1 Eighth2 and Ninth3 Circuit Courts of Appeal decisions have established the “deflection” theory as the governing rule on abandonments. Under that theory, the debtor bears the income tax consequences on abandoned property as the creditor takes the property to satisfy the debt.4 That approach has been criticized as inequitable and as an interference with the debtor’s fresh start.5 However, the deflection theory is made even more painful for the debtor by the fact that the debt on abandoned assets has been characterized as nonrecourse debt.6 That means the entire difference between income tax basis and debt is gain (or loss); there is no discharge of indebtedness income.7

Abandonment

The concept of abandonment rests on the idea that property worth less than what is owed on it has no reason to be in the bankruptcy estate inasmuch as there is nothing of value in such assets for the unsecured creditors.8 The idea is to allow the bankruptcy trustee to abandon the property (usually to the debtor) which enables the secured creditor to pursue the property in satisfaction of the debt.9

The Bankruptcy Code authorizes abandonment in three situations—(1) where property is burdensome to the estate or of inconsequential benefit to the estate, by action of the trustee after notice and a hearing;10 (2) on the same grounds at the request of “a party in interest,” after notice and hearing;11 and (3) where property, at the time of closing of the bankruptcy estate had not been “otherwise administered.”12

Income taxation in abandonment

Neither the Bankruptcy Code nor the Internal Revenue Code is clear as to the income tax consequences of abandonment of property.13 Under the Internal Revenue Code, the movement of property into the bankruptcy estate upon bankruptcy filing does not trigger adverse tax consequences.14 Similarly, the movement of the debtor’s property from the bankruptcy estate to the debtor at the termination of bankruptcy does not result in adverse tax consequences.15 Nothing is said, however, about the income tax consequences of abandonment so that type of transfer is left to be handled under general tax principles.

There are two theories on taxation of abandoned property—

- Under the “entrapment” theory, the abandonment of property to the debtor would trigger income tax liability in which case the tax liability would be trapped in the bankruptcy estate.16
- If, however, abandonment is properly characterized as a “deflection” of property

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bankruptcy estate, the income tax liability when the property is lost to secured creditors would rest with the debtor.\(^2\) The latter theory has become the dominant authority for abandonments.\(^3\)

**Abandonment to a creditor**

One strategy that has been used is to abandon property to a creditor rather than to the debtor.\(^4\) In a 1984 bankruptcy court case, that strategy was employed.\(^5\) However, in a 1993 bankruptcy decision, the bankruptcy court denied abandonment to a creditor at the request of the debtor because of the debtor’s potential income tax liability on farm machinery.\(^6\)

It is not clear whether abandonment to a creditor alters the income tax consequences in light of the decisions embracing the “deflection” theory of income taxation.\(^7\)

**Nature of gain**

A critical issue is how the gain is to be reported when a secured creditor forecloses upon or utilizes another creditor remedy with request to abandoned property. In a 1989 letter ruling,\(^8\) real property of a Chapter 7 debtor had been abandoned to the debtor. The unsecured portion of the mortgage was discharged in bankruptcy. The mortgage, however, survived the bankruptcy. IRS ruled that the taxpayer would realize upon foreclosure of the mortgage the entire remaining secured portion of the mortgage as proceeds of a nonrecourse loan (the personal liability of the taxpayer having been discharged in bankruptcy).\(^9\) Gain was recognized to the extent the remaining mortgage exceeded the taxpayer’s basis in the property after reduction for the discharge of indebtedness in bankruptcy.

In a 2000 Tax Court case,\(^10\) relief from the automatic stay was granted on the taxpayer’s residence with the residence sold in a foreclosure proceeding. The Tax Court held the income tax consequences were the same as abandonment with the full amount between the income tax basis and the debt treated as gain in the manner of treatment of a nonrecourse loan.

Had these transactions been treated as involving recourse debt, the amount between the basis and fair market value would have been gain (or loss)\(^11\) but the amount between fair market value of the property and the amount of discharged debt would have been discharge of indebtedness income.\(^12\) Numerous relief provisions are available to deal with discharge of indebtedness;\(^13\) there is no relief for recognized gain.

**In conclusion**

If bankruptcy filing is motivated in part, at least, by a belief that income tax liability can be avoided on property liquidation, careful attention should be given to the likelihood of abandonment. The income tax consequences of abandonment can be highly disadvantageous for the debtor.

**FOOTNOTES**

2. See In re Olson, 100 B.R. 468 (Bankr. N.D. Iowa 1989), aff’d, 121 B.R. 346 (N.D. Iowa 1990), aff’d, 930 F.2d 6 (8th Cir. 1991) (abandonment of land to debtor; bankruptcy court acknowledged In re McGowan, 95 B.R. 104 (Bankr. N.D. Iowa 1988) was “overbroad” in defining abandonment as “termination of estate” but nonetheless concluded that abandonments should be covered by I.R.C. § 1398(f)(2); Court of Appeals offered no theory for holding that “deflection” theory applied).
3. In re Johnston, 49 F.3d 538 (9th Cir. 1995) (court held requirements for abandonment did not include consideration of effect on debtor’s fresh start).
4. See notes 2 and 3 supra.
5. 5 Harl, supra note 1, § 39.04[2][a][iv].
7. See, e.g., 2925 Briarpark, Ltd. v. Comm’r, T.C. Memo. 1997-298, aff’d, 99-1 U.S.T.C. ¶ 50,209 (5th Cir. 1999) (income from discharge of nonrecourse loans treated as gain and not discharge of indebtedness income).
9. Id.
13. See 5 Harl, supra note 1.
17. See In re Olson, 930 F.2d 6 (8th Cir. 1991); In re Johnston, 49 F.3d 538 (9th Cir. 1995).
18. Id.
20. Id.
22. See notes 2-3 supra.
24. Id.
26. Treas. Reg. § 1.1001-2(c), Ex. 8. See, e.g., Bressi v. Comm’r, T.C. Memo. 1991-651 (capital gain income as to excess of fair market value over basis; discharge of indebtedness income for indebtedness discharged over fair market value of property).
27. Id.
28. See 5 Harl, supra note 1, § 39.03.