Income Tax Consequences of Abandonment

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INCOME TAX CONSEQUENCES OF ABANDONMENT
— by Neil E. Harl*

The income tax consequences of abandonment in bankruptcy1 have posed significant problems for farm and ranch taxpayers for well more than a decade. With two Circuit Courts of Appeal embracing the “deflection” theory, the Eighth2 and Ninth3 Circuit Courts of Appeal decisions assured that a taxpayer filing bankruptcy is highly vulnerable to income tax liability on the property abandoned by the bankruptcy estate.

A 2002 Ninth Circuit Court of Appeals decision4 has provided further insight into what constitutes abandonment.

_Catalano v. Commissioner_

In the Ninth Circuit case of _Catalano v. Commissioner_,5 the taxpayer had borrowed $1.4 million from a bank to purchase a residence which secured the loan. Six years later, the taxpayer ceased making principal and interest payments on the obligation when the taxpayer filed bankruptcy. A year later, the bankruptcy court lifted the automatic stay on the property which permitted the lender to foreclose on the residence. The taxpayer claimed an income tax deduction for the mortgage interest from the foreclosure which the Internal Revenue Service disallowed. The Tax Court held that the relief from the automatic stay removed the property from the bankruptcy estate which resulted, in effect, in abandonment of the property by the bankruptcy estate.6 The Tax Court concluded that the taxpayer was deemed to have paid the accrued mortgage interest in the foreclosure sale. Thus, the taxpayer could claim a deduction for accrued mortgage interest as of the foreclosure date.7

The Ninth Circuit Court of Appeals reversed, stating that, under the Bankruptcy Code, abandonment requires a formal notice and hearing8 which had not occurred in this case. The court noted that property is not considered abandoned from the bankruptcy estate unless the abandonment procedures in the Bankruptcy Code are satisfied. The court rejected the taxpayer's argument that the order lifting the automatic stay accomplished a de facto abandonment of the property. Therefore, the property was not considered abandoned. The taxpayer could not deduct the claimed mortgage interest.

Consequences of abandonment

Had the taxpayer been successful, in arguing that the property had been abandoned back to the taxpayer, the consequences could possibly have been significant and might have been costly to the taxpayer.

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The Ninth Circuit Court of Appeals, the same court that decided the appeal in Catalano v. Commissioner\(^6\) held in 1995 that, in the event of abandonment in bankruptcy,\(^{10}\) the “deflection” theory applies and the taxpayer is liable for any gain on the property when the creditor takes action to acquire the property subsequent to abandonment.\(^{11}\) The Eighth Circuit Court of Appeals agrees with that characterization although that treatment has been rejected by a U.S. Bankruptcy Court in Massachusetts\(^{12}\) and criticized by this author.\(^{13}\)

Even worse, the Internal Revenue Service, in 1989, ruled that abandonment in bankruptcy effectively converts a recourse obligation into a non-recourse obligation (which was already the case in Catalano v. Commissioner)\(^{14}\) with the result that the entire difference between the income tax basis of the property and the amount of the debt was gain to the taxpayer.\(^{15}\) The personal liability of the taxpayer was discharged in bankruptcy. There is no discharge of indebtedness income for non-recourse obligations by the IRS view of the taxation of abandoned property. Discharge of indebtedness for a taxpayer in bankruptcy\(^{16}\) is not subject to income tax (although the taxpayer's tax attributes and basis of property must be reduced).\(^{17}\) Similarly, for insolvent taxpayers not in bankruptcy, there is no income tax liability for discharge of indebtedness income to the extent of the taxpayer's insolvency.\(^{18}\) Even if a farm or ranch taxpayer is solvent, income tax liability may be avoided under the solvent farm debtor rule\(^{19}\) although tax attributes and the basis of property must be reduced.\(^{20}\)

None of the rules apply to non-recourse indebtedness inasmuch as the entire difference between basis of the property and debt is gain and there is no discharge of indebtedness income.

In conclusion
Abandonment of property in bankruptcy is a treacherous concept from an income tax perspective. The reversal of the Tax Court in Catalano v. Commissioner\(^{21}\) narrows slightly the scope of abandonment with the Ninth Circuit Court decision serving notice that abandonment of property requires a formal notice and hearing\(^{22}\) with an unenthusiastic response to arguments for broadening the concept of abandonment in other situations involving a type of constructive or implied abandonment.

FOOTNOTES
2. In re Olson, 930 F.2d 6 (8th Cir. 1991) (abandonment of land to debtor; court offered no theory for holding that deflection approach 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. Catalano v. Comm’r, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,203 (9th Cir. 2002) (relief from stay granted on consideration of effect on debtor’s “fresh start”).
5. 2002-1 U.S. Tax Cas. (CCH) ¶ 50,203 (9th Cir. 2002).
7. Id.
9. 2002-1 U.S. Tax Cas. (CCH) ¶ 50,203 (9th Cir. 2002).
11. In re Johnston, 49 F.3d 538 (9th Cir. 1995).
14. 2002-1 U.S. Tax Cas. (CCH) ¶ 50,203 (9th Cir. 2002), rev’d, T.C. Memo. 2000-82.
19. I.R.C. § 108(g).
20. Id.
21. 2002-1 U.S. Tax Cas. (CCH) ¶ 50,203 (9th Cir. 2002).

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BANKRUPTCY

CHAPTER 13-ALM § 13.03.*

DISPOSABLE INCOME. The debtors’ Chapter 13 plan was confirmed and contained a provision that all income tax returns to which the taxpayers became entitled during the plan were to be included in disposable income. The plan ended on April 4, 2001 and the debtors received a discharge on April 24, 2001.

The trustee then learned that the debtors received an income tax refund for 2000 taxes and sought to include the refund in the disposable income. The court held that the debtors became entitled to the refund on December 31, 2000; therefore, the refund was included in disposable income under the plan. In re Midkiff, 271 B.R. 383 (Bankr. 10th Cir. 2002).

FEDERAL TAX-ALM § 13.03[7].*

DISCHARGE. The U.S. Supreme Court has unanimously decided an issue that has spawned numerous reported decisions that have produced a varied response to the issue of whether a