The economic downturn since 2007 and the rising tide of bankruptcies have focused attention on the consequences of abandonment in bankruptcy. While bankruptcy law in the United States (in contrast to the treatment in some other countries) has long assured individual debtors a “fresh start” in life following bankruptcy, with such debtors in liquidation bankruptcy (Chapter 7) as well as reorganization bankruptcy generally eligible for discharge of debt, the way abandonments in bankruptcy are handled under prevailing case law interferes substantially with the vaunted fresh start after bankruptcy. A 1989 letter ruling issued by the Internal Revenue Service on the handling of abandoned assets which are subjected to foreclosure or other creditor action in the hands of the debtor contributes to the burdens of a debtor and further interferes with the debtor’s fresh start.

**What is abandonment?**

If property of the bankruptcy estate is burdensome to the estate or of inconsequential value to the estate (which usually means the property is worth less than what is owed on it), the property may be abandoned by the bankruptcy trustee or the court may order the trustee to abandon the property on request of a party in interest, after notice and a hearing. A trustee may abandon property of the bankruptcy estate without obtaining a court order authorizing abandonment when there is no objection to the proposed abandonment by an interested party. Abandonment of the property causes the property to be transferred to the debtor in what has been termed a “deflection” of the property from the bankruptcy estate.

**The income tax consequences**

The movement of the property of the debtor into the bankruptcy estate upon filing does not trigger adverse income tax consequences to the debtor. Similarly, the movement of the property from the bankruptcy estate back to the debtor at the termination of the bankruptcy estate is not treated as a disposition of the property. However, the bankruptcy income tax rules say nothing about the tax consequences of abandonments or transfers to third parties (such as where property is abandoned to the creditor).

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If an abandonment is properly characterized as involving a completed transfer to the bankruptcy estate followed by a transfer of the property back to the debtor by abandonment, arguably the retransfer to the debtor would trigger income tax liability, in which case the tax liability would be trapped in the bankruptcy estate (the “entrapment” theory). However, if the abandonment is properly characterized as a “deflection” of the property from the bankruptcy estate, the tax liability when the property is lost to the creditors would rest with the debtor. Indeed, the so-called “deflection” theory has been embraced by Bankruptcy Courts when the property is lost to the creditors would rest with the debtor. The unsecured portion of the mortgage as proceeds of a non-recourse loan (the personal liability of the taxpayer having been discharged in bankruptcy) and recognize gain to the extent the remaining debt exceeded the taxpayer’s basis in the property after reduction for the discharge of indebtedness in bankruptcy.

Thus, not only was the gain on the property taxed to the debtor because of abandonment but the entire difference between the reduced basis and the amount of the debt was income to the debtor. As noted in a recent Digest article, the outcome would have been more favorable under the 2005 Bankruptcy Act amendments (pertaining to Chapter 12 Bankruptcy) as interpreted by the Eighth Circuit Court of Appeals in *Knudsen v. Internal Revenue Service.*

**ENDNOTES**

4 11 U.S.C. §§ 1141(d) (Chapter 11), 1228(a) (Chapter 12), 1328(a) (Chapter 13).
8 11 U.S.C. § 554(a), (b). See, e.g., In re Johnston, 49 F.3d 538 (9th Cir. 1995) (requirements for abandonment did not include consideration of income tax effects on debtor); In re Olson, 930 F.2d 6 (8th Cir. 1991).
9 In re Trim-x, 695 F.2d 296 (7th Cir. 1982).
12 I.R.C. § 1398(f)(2).
13 See In re Butler, 51 B.R. 261 (Bankr. D. C. 1984). But see Matter of Popp, 166 B.R. 697 (Bankr. D. Neb. 1993) (court denied abandonment to creditor requested by debtor because of debtor’s potential income tax liability on farm machinery; bankruptcy court stated that there would be no income tax consequences to debtor under I.R.C. § 1398(f)(2)).
14 See, e.g., In re Cruseturner, 8 B.R. 581, 591 (Bankr. D. Utah 1981): “When the trustee abandons property, the property stands as if no bankruptcy had been filed and the debtor enjoys the same claim to it and interest in it as he held previous to the filing of bankruptcy.”
15 In Matter of Bentley, 916 F.2d 431 (8th Cir. 1990); In re Olson, 930 F.2d 6 (8th Cir. 1991).
16 In re Johnston, 49 F.3d 538 (9th Cir. 1995).
22 I.R.C. § 108.
26 581 F.3d 696 (8th Cir. 2009).