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ABANDONMENT IN BANKRUPTCY

— by Neil E. Harl*

Bankruptcy is designed to accomplish two objectives — (1) assure fair and equitable treatment of the unsecured creditors (the secured creditors are entitled to payment up to the value of their collateral and beyond that are unsecured creditors) and (2) provide a "fresh start" to the debtor.¹ The concept of abandonment now poses a collision of those two objectives.

What is abandonment. In brief, abandonment in bankruptcy may occur whenever property of the bankrupt is worth less than what is owed on it.² The theory behind abandonment is that if the property is worth less than what is owed on it, there is nothing to be gained for the unsecured creditors so the property should be routed back to the secured creditors who are entitled to the value involved. In such a situation, there is no justification to expend bankruptcy resources managing or administering the property in bankruptcy if the assets will pass to the secured creditors in any event.

The Bankruptcy Code specifies how abandonment may occur.³ The usual assumption is that property is abandoned to the debtor with the secured creditors then free to foreclose upon or otherwise seek satisfaction from the property. Abandonment to the creditors has been sanctioned by the bankruptcy courts.⁴

Under the Bankruptcy Code, abandonment may occur in four different circumstances—

- After notice and a hearing, the trustee in bankruptcy may abandon property that is burdensome to the bankruptcy estate or is of inconsequential value and benefit to the estate.⁵ A trustee may abandon property of the estate without obtaining a court order authorizing abandonment when there is no objection to the proposed abandonment by an interested party.⁶

- On the request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.⁷

- Scheduled property not administered before a case is closed

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is deemed abandoned to the debtor and is considered to have been administered.⁸

- Unless the court orders otherwise, property of the estate that is not abandoned and that is not administered in the case remains property of the estate.⁹

A trustee or debtor in possession, unless the court directs otherwise and except for scheduled property which is deemed abandoned if not administered,¹⁰ must give notice of a proposed abandonment or disposition of property to all creditors, indenture trustees and committees.¹¹ An objection may be filed and served by a party in interest within 15 days of the mailing of the notice or within the time fixed by the court.¹² If a timely objection is made, the court is to set a hearing on notice.¹³

Income taxation in abandonment. Unfortunately, neither the Bankruptcy Tax Act of 1980¹⁴ nor any other statute specifies the tax consequences of abandoned property. Accordingly, the question of who bears the income tax liability from the transfer of abandoned property to the secured creditor or from the foreclosure or other satisfaction of abandoned collateral has been left to the courts.¹⁵

What is known. Statutory guidance is provided for some steps in the abandonment process—

- The movement of the debtor's property into the bankruptcy estate upon filing does not trigger adverse tax consequences.¹⁶ The bankruptcy estate is treated as the debtor would have been had the debtor not filed for bankruptcy. Thus, the bankruptcy estate steps into the shoes of the debtor for purposes of *this title* (title 26 of the U.S. Code).¹⁷

- If the bankruptcy estate sells or otherwise disposes of the property (sale of grain at the elevator or livestock through the sale barn, for example) the bankruptcy estate suffers the usual tax consequences of a sale or taxable exchange.¹⁸

- If property remains in the bankruptcy estate at the termination of bankruptcy, the movement of the debtor's property from the bankruptcy estate to the debtor does not trigger adverse tax consequences.¹⁹

Theories of taxation in abandonment. Nothing is said, however, about the tax consequences of abandonments, so that type of transfer is apparently left to be handled under usual tax principles. With that approach, there would seem to be

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two theories for the taxation of gain or loss from abandonments²⁰ —

- 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, arguably the retransfer to the debtor would trigger tax liability in which case any tax liability would be trapped in the bankruptcy estate. Any gain or loss would be reported by the bankruptcy estate and the property would have a basis in the debtor's hands equal to its fair market value. The *entrapment* theory is favorable to debtors and is in accord with the objective of providing the debtor a fresh start in bankruptcy.²¹ As stated in a 1988 bankruptcy court case,²²

"the bankruptcy code provides an honest debtor with a fresh start, free from the burden of past debts....This fresh start has been described as the most extensive 'since the seven year release described in the Old Testament.'"

- However, if an abandonment is properly characterized as a "deflection" of property from the bankruptcy estate, the tax liability when the property is lost to the creditors would rest with the debtor. In support of this characterization, some courts, notably *Mason v. Commissioner*,²³ and *In re Cruseturner*²⁴ have held that the debtor is deemed to have continuously owned the property abandoned in bankruptcy. However, those cases were based on facts arising before enactment of the Bankruptcy Tax Act which provided specifically for the transfer of property "from the debtor to the estate."²⁵

The deflection theory is actually a greater burden for the debtor than would appear at first blush. IRS has taken the position that, because of the discharge of the debtor's personal liability in bankruptcy, the debt survives abandonment as a nonrecourse obligation.²⁶ The outcome is that the fair market value becomes irrelevant and the full difference between the debtor's basis in the property and the amount of the debt is gain (or loss) to the debtor.

Tax cases on abandonment. Four cases, all involving farm facts, have been litigated since 1987.

In the first case, *Estate of Bentley*,²⁷ the debtor had filed Chapter 7 bankruptcy in 1983. The trustee in bankruptcy, the same year, sold a corn crop free and clear of liens with the understanding that the claim of the Commodity Credit Corporation (CCC) would attach to the proceeds and interest earned on the proceeds. In 1986, the trustee determined that the CCC claim was valid and exceeded the value of the crop. Accordingly, the trustee applied to abandon the proceeds. IRS argued that had the corn been abandoned prior to sale, the gain would not have accrued to the bankruptcy estate. However, once the trustee sold the grain, the estate became liable for the income tax on the proceeds. The bankruptcy court stated, surprisingly, that —

"The effect of the IRS position would have the estate pay taxes on property to which the estate is not entitled, did not retain and from which it received no benefit (because it was all abandoned) because the proceeds became property of the estate while subject to a lien which greatly exceeded its value. Such a result will not be countenanced."²⁸

The bankruptcy court decision was reversed by the United States District Court, holding that the proceeds of the corn sale

were taxable to the bankruptcy estate.²⁹ The Eighth Circuit Court of Appeals, in affirming in late 1990, stated—

"...a contrary holding would have the effect of burdening the debtor's fresh start under the bankruptcy law."

The next bankruptcy case on taxation of abandoned property, *In re McGowan*,³⁰ involved the abandonment of the debtor's machinery with a relatively low basis and a substantial amount of potential gain. The bankruptcy court held that the abandonment of bankruptcy estate property by the trustee was not a "sale or exchange" triggering tax liability chargeable to the bankruptcy estate. The bankruptcy court stretched the "termination of the estate" language in the Bankruptcy Tax Act³¹ to cover abandonments.

In the case of *In re Olson*,³² the trustee abandoned land to the debtor. The bankruptcy court acknowledged that *McGowan*³³ was "overbroad" in defining abandonment as "termination of the estate" but nonetheless concluded that abandonments should be covered by the same provision relied upon by the *McGowan* court. Thus, both *McGowan* and *Olson* embraced the deflection theory.

In the case of *In re Olson*³⁴ the bankruptcy trustee failed to file income tax returns for the bankruptcy estate³⁵ so the debtor's accounting firm prepared *and filed* both state and federal fiduciary returns for the bankruptcy estate, duly reporting the sizeable gain. The trustee sued for damages, alleging malicious interference with the trustee's duties. The bankruptcy court agreed the filing was not malicious and indicated a separate hearing would be set on the issue of damages and costs.

In the final case to date, *In re Laymon*,³⁶ the U.S. District Court for Minnesota in 1989 reversed the bankruptcy court and held that the bankruptcy court had erroneously approved the trustee's request for abandonment. At issue was approximately \$17,000 of income tax liability on farmland. The trustee had collected two years of rental on land totaling about \$22,000 before seeking to abandon the property. The court noted that the trustee had a duty to the debtor as well as to the unsecured creditors and pointed out that the trustee has a "general duty not to burden unduly the debtor's opportunities for a fresh start." The court said that the impact of abandonment on debtors "is one aspect to consider on the issue of burdensomeness."

In conclusion. Quite clearly, the entrapment theory is the only approach that will treat debtors fairly and equitably *vis a vis* other debtors.³⁷ Moreover, the entrapment theory is consistent with the idea of providing the debtor a fresh start.³⁸ Finally, it is submitted that the entrapment theory is most consistent with established tax law.

To date, the weight of judicial opinion at the bankruptcy court level has been in favor of the deflection theory. District courts have been less enamored with that approach. The major issue is whether the Eighth Circuit, which has the case of *In re Olson*³⁹ on appeal, will add muscle to the statement that taxing gain to the debtor "would have the effect of burdening the debtor's fresh start under the bankruptcy law."⁴⁰

FOOTNOTES

- ¹ See generally 13 Harl, **Agricultural Law** ch. 120 (1990).
- ² See I.R.C. § 554. See also 4 Harl *supra* N. 1, § 39.02[2][b][iii].
- ³ See 11 U.S.C. § 554.
- ⁴ See *In re* Butler, 51 B.R. 261 (Bankr. D. D.C. 1984).
- ⁵ 11 U.S.C. § 554(a).
- ⁶ Matter of Trim-x, 695 F.2d 296 (7th Cir. 1982).
- ⁷ 11 U.S.C. § 554(b). See *In re* Gantt, 98 B.R. 770 (Bankr. S.D. Ohio 1989) (creditor can only seek motion for trustee to abandon; "notice of proposed abandonment" by secured creditor ineffective).
- ⁸ 11 U.S.C. § 554(c).
- ⁹ 11 U.S.C. § 554(d).
- ¹⁰ 11 U.S.C. § 554(c).
- ¹¹ Bankruptcy Rule 6007(a).
- ¹² *Id.*
- ¹³ Bankruptcy Rule 6007(c).
- ¹⁴ I.R.C. §§ 1398, 1399.
- ¹⁵ See notes 25-34 *infra*.
- ¹⁶ I.R.C. § 1398(f)(1). But see Matter of Rasmussen, 95 B.R. 657 (Bankr. W.D. Mo. (1989) (transfer of assets to bankruptcy estate in Chapter 7 case was taxable exchange with capital gains taxable to debtor; unappealed decision is indeed questionable).
- ¹⁷ I.R.C. § 1398(f)(1).
- ¹⁸ I.R.C. § 61(a)(3).
- ¹⁹ I.R.C. § 1398(f)(2).
- ²⁰ See Harl, Debtor-Creditor Relations: Annotated Materials 1-27, 1-28 (1986); 4 Harl, *supra* note 1, § 39.02[2][b][iii]. See also Nelson, "Taxation of Abandonments in Bankruptcy," 10 J. Agr. Tax'n & L. 221, 224-225 (1988).
- ²¹ See, e.g., *In re* Dias, 95 B.R. 419 (Bankr. N.D. Tex. 1988).
- ²² *Id.*
- ²³ 646 F.2d 1309 (9th Cir. 1980) (involving continuation of S corporation election).
- ²⁴ 8 B.R. 581, 591 (Bankr. D. Utah 1981).
- ²⁵ I.R.C. § 1398(f)(1).
- ²⁶ Ltr. Rul. 8918016, Jan. 31, 1989.
- ²⁷ 79 B.R. 413 (Bankr. S.D. Iowa 1987, *rev'd* 89-2 U.S. Tax Cas. (CCH) ¶ 9597 (S.D. Iowa 1988), *aff'd* 916 F.2d 431 (8th Cir. 1990).
- ²⁸ 79 B.R. 416.
- ²⁹ See N. 27 *supra*.
- ³⁰ 95 B.R. 104 (Bankr. N.D. Iowa 1988).
- ³¹ I.R.C. § 1398(f)(2).
- ³² 100 B.R. 468 (Bankr. N.D. Iowa 1989).
- ³³ See N. 30 *supra*.
- ³⁴ See N. 32 *supra*.
- ³⁵ An income tax return, Form 1041, must be filed by a trustee in bankruptcy or debtor in possession if the bankruptcy estate's gross income was \$2700 or more for years before 1987. I.R.C. §§ 6012(a)(9), 6012(b)(4) (for Chapter 7 or 11 bankruptcy, returns are to be filed by the fiduciary). After 1986, the filing level is set equal to the exemption amount plus the basic standard deduction under I.R.C. § 63(c)(2)(D). Thus, the figure was \$3780 in 1987 rising to \$4450 in 1988, \$4500 in 1989, \$4775 in 1990 and \$5000 in 1991. Moreover, the duty on the part of trustees to file an income tax return existed prior to enactment of the Bankruptcy Tax Act of 1980. *In re* Joplin, 89-2 U.S. Tax Cas. (CCH) ¶ 9483 (10th Cir. 1989).
- ³⁶ Civ. 6-89-235 (D. Minn. 1989).
- ³⁷ See Harl, "Taxing Excess Farm Debt," 45 Tax Notes 885 (1989).
- ³⁸ See N. 21 *supra*.
- ³⁹ See N. 32 *supra*.
- ⁴⁰ See N. 25 *supra*.

CONTROVERSY OVER FILING FORM 1099B

The IRS is reviewing whether agribusiness firms are required to file Form 1099B information returns with the IRS (and with copies to the taxpayer) on purchases of generic commodity certificates from farmers and contracts with farmers for future delivery of grain. The issue is of substantial importance to country elevators and other grain, feed and processing firms.

The controversy grew out of an audit of two trucker-dealers of grain in Illinois. In one of the cases, proposed fines amounted to \$200,000 for failure to file Form 1099B on transactions involving forward grain contracts and generic commodity certificates. Under I.R.C. § 6045, IRS is empowered to require that "brokers" file Form 1099B on transactions involving customers who are sole proprietorships and partnerships. A "broker" is defined as a dealer and "any other person who (for a consideration) regularly acts as a middleman with respect to property or services." I.R.C. § 6045(c)(1)(C). Treas. Reg. § 1.6045-1(a) provides-

"(1) The term "broker" means a person that, in the ordinary course of a trade or business during the calendar year, stands ready to effect sales to be made by others.

"(2) The term "customer" means, with respect to a sale effected by a broker, the person (other than such broker) that makes the sale, if the broker acts as-

"(i) An agent for such person in the sale;

"(ii) A principal in the sale; or

"(iii) The participant in the sale responsible for paying to such person or crediting such person's account the gross proceeds on the sale."

The tax definition of "broker" is much broader than the definition used generally in the grain trade. The National Grain and Feed Ass'n Grain Trade Rule 40 specifies that a "broker" is-

". . . one who is engaged for others, on a commission basis, in negotiating contracts relative to property with the custody of which, actual or constructive, he has no concern."

Under the grain usage, a grain dealer who takes actual or constructive title to the grain generally is thought of as a grain merchandiser rather than a broker. The tax law definition, however, does not preclude those who take title to property from being a broker.

The facts of one of the Illinois cases have been referred to the national office of IRS for a technical advice memorandum. A decision by IRS is likely to be several weeks away.