AMERICAN BANKRUPTCY INSTITUTE

2021 Virtual Annual Spring Meeting

What Do I Do with This 1099 Form from the IRS? Cancellation of Debt Income: A Ticking Time Bomb?

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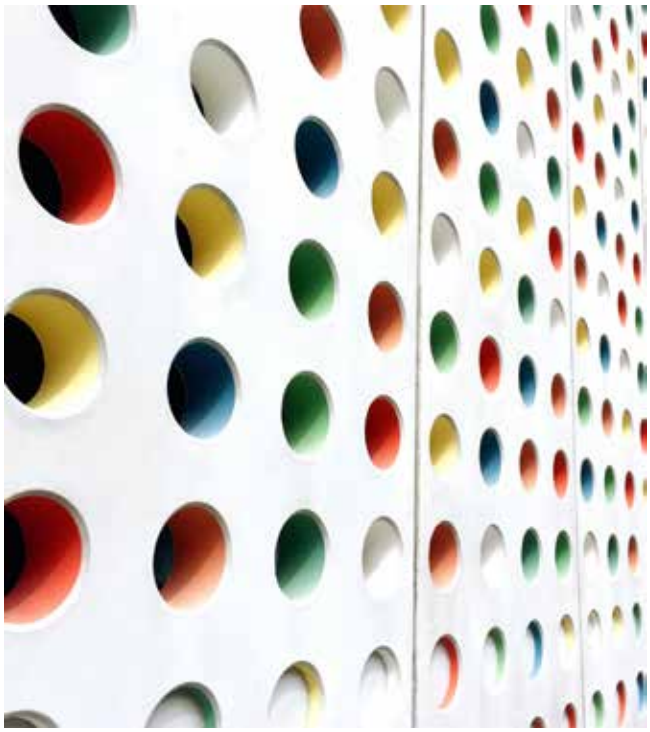
CONCURRENT SESSION

2021



Cancellation of Debt Income

THIS PRESENTATION HAS BEEN PREPARED FOR INFORMATIONAL PURPOSES ONLY, AND IS NOT INTENDED TO PROVIDE, AND SHOULD NOT BE RELIED ON FOR, TAX, LEGAL OR ACCOUNTING ADVICE. YOU SHOULD CONSULT YOUR OWN TAX, LEGAL AND ACCOUNTING ADVISORS REGARDING YOUR SITUATION.

American Bankruptcy Institute, Annual Spring Meeting 2021

Franklind Lea, CIRA

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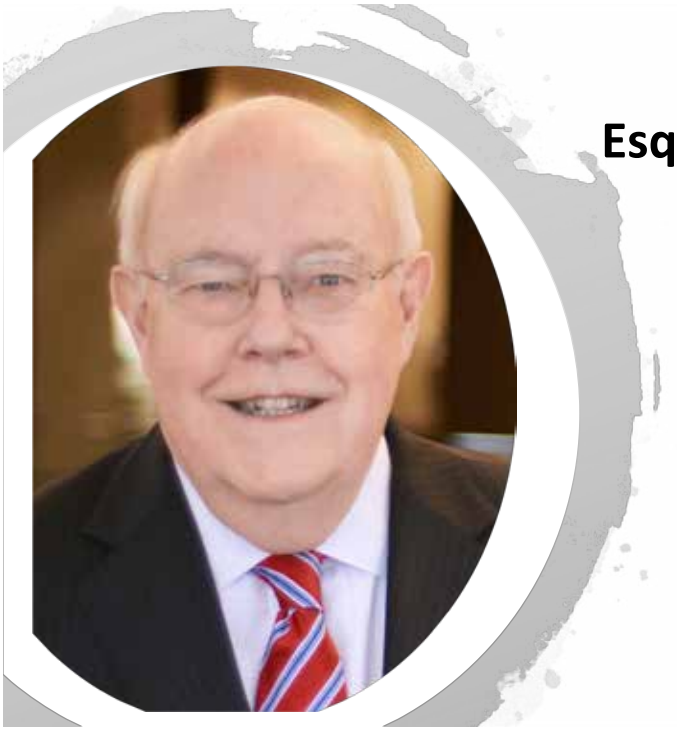
Franklind Lea is routinely called upon to form expert opinions and testify in complex financial matters involving financial disputes, bankruptcy and solvency issues, feasibility, interest rates, and real estate.

He has nearly 30 years of professional experience and education in banking, investment management, financial analysis, commercial lending, debt structuring, real estate, and financial restructuring and workouts.
He holds an undergraduate degree in business, a master's degree in business administration, and a master's degree in real estate valuation. His professional roles have been as an appraiser, commercial lender, credit officer, financial consultant, and workout officer.

During his career, he has been fortunate to work in nearly forty states on a broad array of assignments spanning many industries and business types. Most of his work has been on deals valued between two million and twenty million dollars, but clients have also entrusted him in critical roles where over one billion was invested. These experiences have given him a deep perspective on various businesses, markets, and people that could not have gained in any other way.



Richard Carmody, Esquire

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Richard Carmody has practiced law for more than 45 years, has a nationwide reputation for solid counsel in the field of insolvency law (C&I) and secured lending, and has a network of referral sources that he has developed throughout his career. In 1992, Richard became the first lawyer in Alabama to become certified as a specialist in Business Bankruptcy by the American Board of Certification.

On the state level, Richard helped establish and served as the first chair of the Alabama State Bar section on bankruptcy and commercial law. In 2017, the Alabama State Bar presented Richard with the Albert L. Vreeland Pro Bono Award.

Nationally, Richard is a founding member of the ABI, and he established and served as co-chair of the Ethics Committee. Additionally, he served as vice chair of the ABI's 2013 Task Force for Ethical Standards. He was honored as the ABI Committee Member of the Year in 2012. Currently, he serves on the Veterans Task Force. Richard was inducted as a Fellow in the American College of Bankruptcy in 1999.

Virginia L. Tate, CFE,CIRA, EA

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Virginia Tate is the president of Tate & Associates, FAI International – Forensic Accounting & Investigations, divisions of the EP Global – Elk Point Enterprises Incorporated. Virginia heads up the Tax, Accounting and Forensic Division which focuses on Litigation Support-Taxation-Investigation with clientele through-out the world.

She is a Certified Fraud Examiner, a Certified Insolvency and Restructuring Accountant and an Enrolled Agent licensed by the US Treasury with extensive professional development and training in complex taxation issues, strategic tax planning, business succession, fraud, damages/loss calculations and financial investigations. Virginia is a member of the American Bankruptcy Institute, serving as co-chair of the ABI's Commercial Fraud Committee and member of both Litigation and Taxation Committees.

Prof. Jack Williams
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Jack Williams is a Professor at Georgia State University College of Law and the Middle East Studies Center. He is also a Principal and Team Leader in the Restructuring & Consulting Services Group with Baker Tilly US, LLP. My areas of interest include bankruptcy & restructuring, debt, taxes, forensic accounting, valuations, remedies, veterans issues, marine archaeology, Tribal law, and business law.

He served as the inaugural Robert M. Zinman ABI Scholar in Residence in 2001 and returned to that post in 2008. In 2009, he was recognized by the ABI with its Annual Service Award (2009), honoring the ABI member whose contributions over the past year have been extraordinary.

He is a Fellow in the American College of Bankruptcy and a Fellow in the Bankruptcy Policy Institute at St. John's University School of Law. He presently serves as a co-chair for the ABI Task Force on Veterans and Servicemembers Affairs and as Resident Scholar for the Association of Insolvency & Restructuring Advisors.

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Why is this an Important Topic?

Each statement below, is from a separate case, was included in the Debtors' Disclosure Statement with no accompanying financial analysis, explanation of the tax impact, or income tax charges in the Debtor's projected income!

DISCLOSURE STATEMENT

TAX RAMIFICATIONS TO DEBTOR

Debtor believes that the forgiveness of indebtedness which may result from a discharge granted by the confirmation of the Plan will not result in any significant adverse tax consequence to the Debtor.

DISCLOSURE STATEMENT

TAX CONSEQUENCES - No Representation on Taxes

The tax consequences resulting from confirmation of this Plan can vary greatly among the various Classes of Creditors and Holders of Interests, or within each Class. Significant tax consequences may occur as a result of confirmation of the Plan under the Internal Revenue Code and pursuant to state, local and foreign tax statutes. Because of the various tax issues involved, the differences in the nature of the Claims of various Creditors, the taxpayer statute and method of accounting and prior actions taken by Creditors, . . . no specific tax consequences to any Creditor or Holder of an Interest are represented, implied, or warranted.

DISCLOSURE STATEMENT

CERTAIN U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE PLAN TO THE DEBTOR

As noted above, because the Debtor is a "pass through" entity, the Plan will have relatively few direct Federal Income Tax consequences to the Debtor. Instead, these tax consequences must be analyzed at the Holder's level, as discussed above.

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Why is this an Important Topic?

PROJECTIONS	2020	2021	2022	2023	2024
REVENUES					
RENTAL INCOME	452,000	506,240	566,989	635,027	711,231
CAM COLLECTIONS	60,000	67,200	75,264	84,296	94,411
PROPERTY INSURANCE INCOME	10,000	11,200	12,544	14,049	15,735
MISCELLANEOUS	6,200	6,944	7,777	8,711	9,756
VACANCY ALLOWANCE	(45,200)	(50,624)	(56,699)	(63,503)	(71,123)
TOTAL INCOME	**483,000**	**540,960**	**605,875**	**678,580**	**760,010**
EXPENSES					
ADVERTISING/MARKETING	16,000	17,920	20,070	22,479	25,176
CAM EXPENSE	61,000	68,320	76,518	85,701	95,985
INSURANCE	29,400	32,928	36,879	41,305	46,261
REPAIRS AND MAINTENANCE	8,925	9,996	11,196	12,539	14,044
REAL ESTATE TAXES	27,798	31,134	34,870	39,054	43,741
TOTAL OPERATING EXPENSES	**143,123**	**160,298**	**179,533**	**201,078**	**225,207**
CASH FLOW / INCOME (LOSS) FROM OPERATIONS	**339,877**	**380,662**	**426,342**	**477,503**	**534,803**
PLAN PAYMENTS					
CLASS 1	12,000				
CLASS 2	7,500	7,500	7,500		
CLASS 3	25,000	25,000	25,000	25,000	25,000
CLASS 4	125,000	125,000	125,000	125,000	125,000
TOTAL PLAN PAYMENTS	**169,500**	**157,500**	**157,500**	**150,000**	**150,000**
BEGINNING CASH	60,000	230,377	453,539	722,381	1,049,884
EXCESS (SHORTFALL) CASH FLOW	170,377	223,162	268,842	327,503	384,803
ENDING CASH	**230,377**	**453,539**	**722,381**	**1,049,884**	**1,434,687**

This proforma demonstrates a common practice of not including a Debtor's anticipated income tax charges on projected income, cash flow and cash balances resulting from the Debtor's restructuring.

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Audience Questions

Please enter in the chat box!

Also note that many additional topic references are included within the slides.

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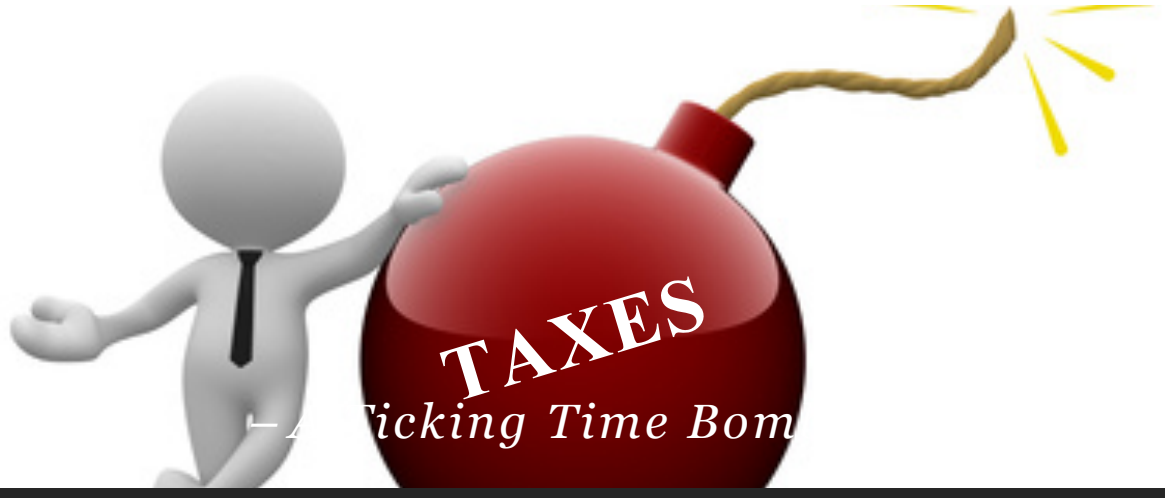

The Intersection of the IRS Code and the Bankruptcy Code

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The Basic Concept of COD Income

Key Code, Cases & Regulations

Topic No. 431 Canceled Debt – Is It Taxable or Not?
https://www.irs.gov/taxtopics/tc431

In general, one has *Cancellation of Debt (COD) Income* when their debt is canceled, forgiven, or discharged ("voided") for less than the amount owed.

While this may create a (tax) loss to the taxpayer who is owed, it creates (taxable) income to the taxpayer whose debt was voided unless the taxpayer can find a rule of exception, exclusion or deferment.

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When Might COD Income Occur?

ACQUISITION OR ABANDONMENT OF SECURED PROPERTY

If you borrow money from a lender to purchase property, the lender may require the loan to be secured by the purchased property. If you transfer the ownership of the secured property to the lender (such as in a foreclosure) or abandon the property under state law , the law may require you to treat the transfer or the abandonment as a sale of the property.

CANCELLATION OR WRITE-DOWN OF DEBT

When you borrow money, you don't include the loan proceeds in gross income because you have an obligation to repay the lender later. If the lender subsequently cancels that obligation (or a portion of it), you may be required to include the amount of the canceled debt in gross income.

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Three Examples COD Income Generation

RELEASE OR REDUCTION OF DEBT

Taxpayer Joe can no longer afford to pay his debt of $10,000. Lender agrees to release Taxpayer Joe's $10,000 debt for a single payment of $4,000.

Taxpayer Joe must recognize $6,000 of COD Income.

WRITEDOWN OF INDEBTEDNESS

Taxpayer ABC Corporation, a C-Corporation, can no longer afford to pay its $500,000 mortgage loan to the Bank for its building. The building has declined in value to $350,000. Bank agrees to rewrite the loan to the current value of its collateral; the new loan is $350,000.

Taxpayer ABC Corporation must recognize $150,000 of COD Income

TRANSFER OF PROPERTY IN FULL OR PARTIAL SATISFACTION OF INDEBTEDNESS

Taxpayer Samantha borrowed personally for her purchase of a beachfront rental property. Sadly, it has been vacant most of the past year and she cannot make the payments. The loan balance is $1,000,000 and the property's fair market value is $800,000. Bank agrees to accept the property's title in full satisfaction of the debt.

Samantha must recognize $200,000 of COD Income.

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Exclusions and Exceptions – What's the Difference & Why Does It Matter?

If a debt is forgiven or discharged for less than the full amount owed, the debt is considered canceled in the amount that you don't have to pay. If no tax is due on the cancelled debt, this is (generally) known as an *exclusion*. However, the law provides several *exceptions* in which the amount you don't have to pay isn't canceled debt.

- If the canceled debt isn't taxable because it is one of the EXCEPTIONS, the law specifically allows you to exclude it from gross income. In other words, it is not shown as income on your tax return!
- Generally, if you exclude canceled debt from income under one of the EXCEPTIONS, you must reduce certain tax attributes (certain credits and carryovers, losses and carryovers, basis of assets, etc.) (but not below zero) by the amount excluded.
- In general, if you have cancellation of debt income the amount of the canceled debt is taxable and you must report the canceled debt on your financial statements and tax return for the year the cancellation occurs.

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How do I know if the Debt is Forgiven?

Generally, the date of a debt discharge is the date that an "identifiable event" occurs pursuant to Treas. Reg. Sec. 1.6050P-1(b)(1). Identifiable events that constitute the discharge of debt include:

- the expiration of the statute of limitations for collection,
- an election of foreclosure remedies by a creditor,
- a debt's being rendered unenforceable pursuant to a probate or similar proceeding,
- an agreement between an "applicable entity" and a debtor to discharge indebtedness at less than full consideration, and
- certain decisions by the creditor.

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When Might the Cancellation of Debt Not Create Income? – EXCEPTIONS!

Key Code, Cases & Regulations

Topic No. 431 Canceled Debt – Is It Taxable or Not?

https://www.irs.gov/taxtopics/tc431

EXCEPTIONS from Gross Income

1. Amounts canceled as gifts, bequests, devises, or inheritances
2. Certain qualified student loans canceled under the loan provisions that the loans would be canceled if you work for a certain period of time in certain professions for a broad class of employers
3. Certain other education loan repayment or loan forgiveness programs to help provide health services in certain areas
4. Amounts of canceled debt that would be deductible if you, as a cash basis taxpayer, paid it [a/k/a Lost Deduction(s)]
5. A qualified purchase price reduction given by the seller of property to the buyer (a/k/a Purchase Price Adjustments)
6. Any Pay-for-Performance Success Payments that reduce the principal balance of your home mortgage under the Home Affordable Modification Program
7. Amounts from student loans discharged on the account of death or total and permanent disability of the student
8. Bona fide disputes
9. Stock-for-Debt transactions and Partnership Interest for Debt transactions
10. Contribution of Capital Exception

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When Might the Cancellation of Debt Not Create Income? – EXCLUSIONS!

Key Code, Cases & Regulations

Topic No. 431 Canceled Debt – Is It Taxable or Not?

https://www.irs.gov/taxtopics/tc431

EXCLUSIONS from Gross Income

1. Debt canceled in a Title 11 bankruptcy case
2. Debt canceled to the extent insolvent (but not in bankruptcy)
3. Cancellation of qualified farm indebtedness
4. Cancellation of qualified real property business indebtedness
5. Cancellation of qualified principal residence indebtedness that is discharged subject to an arrangement that is entered into and evidenced in writing before January 1, 2021
6. Certain student loan debts
7. Certain debts from residential properties under the Mortgage Forgiveness Debt Relief Act of 2007
8. Gain from sale of Principal Residence (subject to limitations under IRC Section 121)

****** Generally, if you exclude canceled debt from income under one of the exclusions listed above, you must reduce certain tax attributes (certain credits and carryovers, losses and carryovers, basis of assets, etc.) (but not below zero) by the amount excluded. ******

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General Insolvency Exception

Key Code, Cases & Regulations

- IRC § 108(a)(1)(C), (g)(2)(A)-(B)
- Campbell v. C.I.R., 28 F. App'x 613 (8th Cir. 2002)
- IRC § 108(a)(1)(A)
- Schachner v. C.I.R., No. 23478-05S (Tax Court 2006)
- IRC § 108(b)(2)(A)-(G)
- IRC § 108(d)(2)

In situations where a discharged or reduced debt is to an insolvent taxpayer, the amount of the discharged debt is excluded from gross income and not taxable.

HOWEVER, a debtor must adjust its tax attributes! Among other things, the Tax Attributes include the debtor's basis in the property and any net operating loss (NOL) carryforwards.

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What happens to a Bankruptcy-Discharged (or Adjusted) Debt?

Key Code, Cases & Regulations

- IRC § 108(a)(1)(C), (g)(2)(A)-(B)
- Campbell v. C.I.R., 28 F. App'x 613 (8th Cir. 2002)
- IRC § 108(a)(1)(A)
- Schachner v. C.I.R., No. 23478-05S (Tax Court 2006)
- IRC § 108(b)(2)(A)-(G)
- IRC § 108(d)(2)

In cases of bankruptcy discharged or reduced debt, the amount of the discharged debt is excluded from gross income and not taxable.

HOWEVER, a debtor must adjust its tax attributes! Among other things, the Tax Attributes include the debtor's basis in the property and any net operating loss (NOL) carryforwards.

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Who's Responsibility is it to Report COD? (IRS Publication 431)

Key Code, Cases & Regulations

See Topic No. 431 Canceled Debt – Is It Taxable or Not? | Internal Revenue Service (irs.gov)

After a debt is canceled, the creditor **may** send you a Form 1099-C, Cancellation of Debt showing the amount of cancellation of debt and the date of cancellation, among other things. If you received a Form 1099-C showing incorrect information, contact the creditor to make corrections. *For example, if the creditor is continuing to try to collect the debt after sending you a Form 1099-C, the creditor may not have canceled the debt and, as a result, you may not have income from a canceled debt.* You should verify with the creditor your specific situation.

Your responsibility to report the taxable amount of canceled debt as income on your tax return for the year when the cancellation occurs doesn't change whether or not you receive a correct Form 1099-C.

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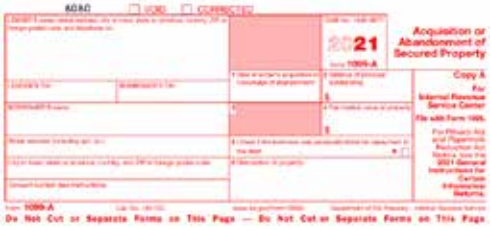
Forms 1099-A and 1099-C

Acquisition or Abandonment of Secured Property or Cancellation of Debt

1099-A

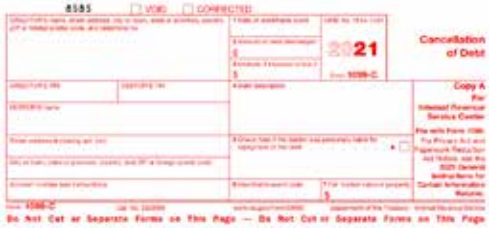
ACQUISITION OR ABANDONMENT OF SECURED PROPERTY



*Certain lenders who acquire an interest in property that was security for a loan or who have reason to know that such property has been abandoned must provide you with this statement. You **may** have reportable income or loss because of such acquisition or abandonment.*

1099-C

CANCELLATION OF DEBT



You received this form because a federal government agency or an applicable financial entity (a creditor) has discharged (canceled or forgiven) a debt you owed, or because an identifiable event has occurred that either is or is deemed to be a discharge of a debt of $600 or more.

Key Code, Cases & Regulations

Topic No. 432 Form 1099-A (Acquisition or Abandonment of Secured Property) and Form 1099-C (Cancellation of Debt) | Internal Revenue Service (irs.gov)

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Disputed Debt Doctrine

Key Code, Cases & Regulations

- IRC § 108
- Treas. Reg. § 1.1441-2(d)-(e)
- IRC § 61(a)(12) - Gross income includes "income from discharge of indebtedness"
- Third Circuit Court of Appeals, Zarin v. Commissioner, 916 F.2d 110 (3rd Cir. 1990)
- Second Circuit Court of Appeals, Lamm v. Commissioner, 873 F.2d 194 (1989)
- Ten Circuit of Court of Appeals, Preslar v. Commissioner, 167 F.3d 1323,1238 (1999)
- N. Sobel, Inc. v. C.I.R., 40 BTA 1263 (1939)
- Estate of Smith v. C.I.R., 198 F.3d 515 (5th Cir. 1999)
- Lamm v. C.I.R., 873 F.2d 194 (8th Cir. 1989)

The Disputed Debt Doctrine, also known as the Contested Liability Doctrine, is an exception to the requirement to include COD income.

- the amount of debt must actually be (good faith) dispute
- focus must be on the amount of the underlying debt
- legally enforceable

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What happens to a Fraudulent Debt?

Key Code, Cases & Regulations

Rev. Rul. 92-99 (seller obtained a higher purchase price by misrepresentation of material fact)

Zarin v. C.I.R., 916 F.2d 110, 113 (3d Cir. 1990)

Collins v. C.I.R., 3 F.3d 625 (2d Cir. 1993)

In cases of fraud, illegality, material misrepresentation, and the like any proceeding/settlement resulting in a cancellation of debt also excludes the amount of the cancellation from gross income.

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Interesting Case Involving Student Loans and Fraud Claims

After a private school closed, some of its students who had taken out private student loans sued their lenders and the school for, among many other things, an injunction profiting the lenders from enforcing or collecting the loans.

The lenders settled these claims by, among other things, providing debt forgiveness.

While the discharge of indebtedness is considered gross income and taxed, the IRS issued a letter finding that this particular settlement may be an exception to that general rule. (*See* IRS Info. Letter 2010-0141; *see also* In RevRul 92-99, 1992-2 CB 34.)

Under 28 U.S.C. Sec. 108(e)(5), a debt reduction may be excludable as a purchase price adjustment if: (1) the debt of the purchaser of property to the seller arising out of the purchase is reduced; (2) the debt reduction does not occur in a bankruptcy or when the purchaser is insolvent; and (3) the reduction would be treated as income to the purchaser from the discharge of indebtedness but for Sec. 108(e)(5).

So the IRS opined that the debt forgiveness could be considered as a compromise of *many* claims, including fraud, aiding and abetting fraud, negligent misrepresentation, violations of consumer protection laws, and so on.

Thus, the debt forgiveness may actually be considered a purchase price adjustment based on an infirmity relating back to the provision of educational services.

Purchase Price Adjustment Exception

If a seller reduces the debt on property sold to a buyer, then the purchase price is reduced not the amount of the debt.

Key Code, Cases & Regulations

- IRC § 108(e)(5)

Seller sells a shiny Widget for $100 for a $20 down payment and finances the remainder of the purchase price. After one year the seller complains about the lack of widget's luster and the seller agrees to a $20 price reduction.

	Original Transaction	Don't Do This!	Do This Instead!
Purchase Price	$100	$100	$100 - $20 = $80
Down Payment	$20	$20	$20
Seller Financing	$80	$80-$20 = $60	$80-$20 = $60

The correct treatment is a purchase price adjustment and not a discharge of indebtedness, and cancellation of debt income is avoided.

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Qualified Real Property Business Indebtedness

Key Code, Cases & Regulations

- IRC § 108(a)(1)(C), (g)(2)(A)-(B)
- https://www.irs.gov/pub/irs-pdf/p4681.pdf#page=8
- Campbell v. C.I.R., 28 F. App'x 613 (8th Cir. 2002)

A qualified real property indebtedness if the debt was incurred in connection with real property used in a trade or business, other than a farm debt or real property developed and held primarily for sale to customers in the ordinary course of business. The debt must also be secured by the real property.

If the debt meets this description, then it likely qualifies as a qualified real property indebtedness and the amount of the discharged debt is excluded from gross income and not taxable. However, a debtor must adjust its tax attributes first and is limited to a deduction no greater than debt's principal amount over the property's fair market value or the property's adjusted basis at the time the debt was cancelled.

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Qualified Farm Indebtedness

Key Code, Cases & Regulations

- IRC § 108(a)(1)(C), (g)(2)(A)-(B)
- https://www.irs.gov/pub/irs-pdf/p4681.pdf#page=8
- Campbell v. C.I.R., 28 F. App'x 613 (8th Cir. 2002)

If the discharged or reduced debt was directly incurred as part of farming business with 50% or more of the individual's gross receipts from farming, then it likely qualifies as a farm indebtedness and the amount of the discharged debt is excluded from gross income and not taxable.

However, a debtor must adjust its tax attributes prior to using the qualified farm indebtedness exclusion and other rules apply if the debt is cancelled as part of the bankruptcy or insolvency. The amount of income excluded cannot exceed your adjusted tax attributes or the basis of the property (in other words, you cannot turn the exclusion into a credit.)

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Qualified Principal Residence Indebtedness

Key Code, Cases & Regulations

- Do I Have Cancellation of Debt Income on My Personal Residence? https://www.irs.gov/help/ita/do-i-have-cancellation-of-debt-income-on-my-personal-residence
- https://www.irs.gov/forms-pubs/about-publication-4681
- IRC § 108(a)(1)(C), (g)(2)(A)-(B)
- Campbell v. C.I.R., 28 F. App'x 613 (8th Cir. 2002)

The Mortgage Forgiveness Debt Relief Act of 2007(MFDRA) provides tax relief to who would owe taxes on their principle residence upon foreclosure. It was enacted as part of the economic reform acts during the Great Recession to eliminate or reduce the amount of income owed from home mortgage debt on "qualified principal residence indebtedness".

Generally, to be a qualified principal residence indebtedness, the debt must be related to any mortgage loan used to buy, build, or substantially improve your main home, and secured by that home.

Foreclosures or mortgage modifications generate three distinct scenarios and while each is treated favorably, each one is also somewhat differently with the most generous treatment applied to traditional purchase financing. The possibilities are:

1. **Loan Results from Purchase borrowing**
2. **Loan Results from cash out Refinance**
3. **Mortgage reduction with Home Retained**

The IRS describes the treatment for each scenario, in detail, in its Publication 4681. The maximum exclusion under this Act is $750,000.

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Example – Typical Residential Foreclosure

Cameron buys a house (at market value) for $500,000 to be his principal residence. To do so, he pays $25,000 as a down payment (95% LTV) and borrows the remaining $475,000. He also takes personal liability (recourse) for the debt.

He makes several payments before defaulting reducing the principal balance (net of accumulated interest and lender expenses at the foreclosure) by $25,000 (outstanding balance of $450,000.) At the time of foreclosure, the value of house has declined to an appraised value of $350,000. At the foreclosure sale, the high bid was $300,000 and not accepted by the lender, who then took title to the property.

Assume Cameron has a tax rate of 25%.

1. What is the amount of Cancellation of Debt Income? Does he have a gain or loss associated with foreclosure?

2. How much tax does Cameron owe?

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Example 1 – Typical Residential Foreclosure

FACTS

Cameron buys a house (at market value) for $500,000 to be his principal residence. To do so, he pays $25,000 as a down payment (95% LTV) and borrows the remaining $475,000. He also takes personal liability (recourse) for the debt.

He makes several payments before defaulting reducing the principal balance by $25,000 (net of accumulated interest and lender expenses at the foreclosure) leaving an outstanding balance of $450,000. At the time of foreclosure in June 2020, the value of house has declined to an appraised value of $350,000. At the foreclosure sale, the high bid was $300,000 and not accepted by the lender, who then took title to the property.

ANSWER - KEY POINTS

Recourse Loan, Borrower does not retain property, satisfies the MFDRA exclusion requirements (date, amount, ownership and usage)

	Gain(Loss)	COD Income
Recourse Debt		$450,000
Basis	$500,000	
Fair Market Value	$350,000	$350,000
	-$150,000	$100,000

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Example 1 – Typical Residential Foreclosure (Cont'd)

DETAILED ANSWER

Cameron experienced a net loss of -$150,000

Cameron experienced a COD income of $100,000

Since the debt was recourse, his primary residence, and otherwise qualified, the transaction qualifies for Mortgage Forgiveness Debt Relief Act

ANSWER - KEY POINTS

Recourse Loan, Borrower does not retain property, satisfies the MFDRA exclusion requirements (date, amount, ownership and usage)

	Gain(Loss)	COD Income
Recourse Debt		$450,000
Basis	$500,000	
Fair Market Value	$350,000	$350,000
	-$150,000	$100,000

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Audience Questions

Please see your chat box!

Please see your chat link for a question about a future topic?

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Are All Types of Entities Treated the Same?

- **Sole Proprietor**
- **Partnership**
- **S-Corporation**
- **LLC** (Treated as a Disregarded Entity)
- **LLC** (Which has elected to be taxed as a Corporation or Partnership)
- **C-Corporation**
- **Non-Profit Corporation**

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Adjusting the Tax Attributes

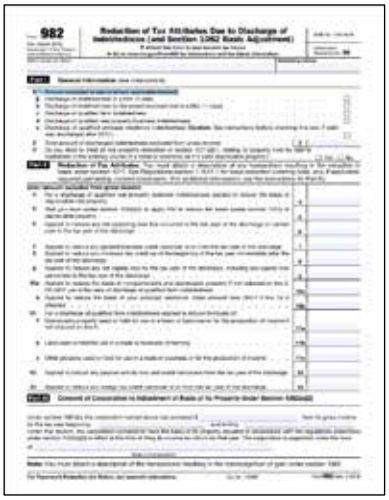
Tax Attributes are specific economic benefits provided by the Tax Code. The IRS recognizes seven types of tax attributes.

Key Code, Cases & Regulations

About Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment) | Internal Revenue Service (irs.gov)

The Internal Revenue Code stipulates that taxpayers must reduce seven tax attributes in the following order:

1. Prior Net Operating Loss
2. General Tax Credit Carryovers
3. Alternative Minimum Tax Credit
4. Capital Loss
5. Cost Basis of Owned Property
6. Passive Activity Loss
7. Foreign Tax Credit Carryover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The CARES ACT

"Double Dipping" Allowed

Forgivable PPP payments

Retroactive NOL usage ("Carrybacks")

Congress specifically addressed the treatment of such expenses in the Consolidated Appropriations Act, signed into law on December 27, 2020 ("2021 Appropriations Act"). The 2021 Appropriations Act, contrary to the position taken by the IRS in Notice 2020-32, clarified by statute that recipients of PPP loans are permitted to take any deductions that would otherwise be allowable for expenses paid with proceeds from a forgiven PPP loan. This provision provides taxpayers with a potential double benefit – potential exclusion from income of a PPP loan, as well as an income tax deduction for expense paid with the proceeds of such PPP loan.

Under the CARES Act, NOLs arising in tax years beginning after December 31, 2017, and before January 1, 2021 (e.g., NOLs incurred in 2018, 2019, or 2020 by a calendar-year taxpayer) may be carried back to each of the five tax years preceding the tax year of such loss.

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How is COD Income for Student Loans Treated?

Key Code, Cases & Regulations

https://www.irs.gov/newsroom/irs-and-treasury-issue-guidance-for-students-with-discharged-student-loans-and-their-creditors

See Rev. Proc. 2020-11

FRAUD ISSUES - There is some forgiveness of COD income existing in the current tax law. The IRS has created a safe harbor to provide relief to taxpayers (both parents and students) who took out federal or private loans to finance attendance at certain educational institutions alleged to have participated in unlawful business practices, including unfair, deceptive, and abusive acts and practice.

See Revenue Procedure 2020-11 for additional details.

SOCIAL INCENTIVES - Certain qualified student loans canceled under the loan provisions that the loans would be canceled if you work for a certain period of time in certain professions for a broad class of employers.

Certain other education loan repayment or loan forgiveness programs to help provide health services in certain areas.

COMING ATTRACTIONS? - The American Rescue Plan Act of 2021 has included a section to expand the tax forgiveness on cancelled student loan debt, even though the Act itself does not include a cancellation of such debt. It is thought to be setting this benefit up for future legislative / administrative actions.

See next slide *and The American Rescue Plan Act of 2021 for additional details.*

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The American Rescue Plan Act of 2021

Prospective forgiveness of income on some student loans

Key Code, Cases & Regulations

https://www.irs.gov/newsroom/irs-and-treasury-issue-guidance-for-students-with-discharged-student-loans-and-their-creditors

SEC. 9675. MODIFICATION OF TREATMENT OF STUDENT LOAN FORGIVENESS.

(a) IN GENERAL. — Section 108(f) of the Internal Revenue Code of 1986 is amended by striking paragraph (5) and inserting the following:

''(5) SPECIAL RULE FOR DISCHARGES IN 2021 THROUGH 2025.—Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) after December 31, 2020, and before January 1, 2026, of —

''(A) any loan provided expressly for postsecondary educational expenses, regardless of whether provided through the educational institution or directly to the borrower, if such loan was made, insured, or guaranteed by —

''(i) the United States, or an instrumentality or agency thereof,

''(ii) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof, or

''(iii) an eligible educational institution (as defined in section 25A),

''(B) any private education loan (as defined in section 140(a)(7) of the Truth in Lending Act),. . .

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What happens to a Guarantor?

Excluded from Gross Income But…

For a more complete discussion, see Cancellation of Debt Income and Its Impact on Loan Workouts, November 25, 2016, Scott N. Opincar, *McDonald Hopkins LLC*

Most cases hold that a taxpayer does not realize COD income if the taxpayer did not receive anything of value when the indebtedness was incurred. In Landreth v. Commissioner, 50 T.C. 803 (1968), the Tax Court found that a guarantor does not realize COD income when the underlying debt is paid. This is also true if the underlying obligation is not paid and the guarantor becomes liable for the indebtedness. Landreth at 813. TC Memo 1996-83.

The IRS generally agrees that a guarantor (whether or not the primary obligor has defaulted and the guarantor has become liable for the indebtedness) does not realize COD income on release of a liability. IRC 108(e)(2). See also, IRS Memo 61.09-18. INFO 2002-0024.

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Related Party Debt Acquisitions

For a more complete discussion see,
https://www.lexology.com/library/detail.aspx?g=c21c85f6-2ebe-4350-a830-a60024061455
By Dennis L. Cohen and Thomas Gallagher (Cozen O'Conner)

COD income cannot be avoided by having a person or entity within the same economic unit as the borrower acquire the borrower's debt at a discount from an unrelated holder.

IRC Section 108(e)(4) indicates who are related parties, such as family members, certain shareholders, partners and beneficiaries, 50% or greater owners, and control group that acquire the borrower's debt.

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Guarantors – Some Additional Issues to Consider

Should potential COD Income affect the structure chosen to be the borrower?

What are the potential cost, benefits, and risks of a pass-through entity?

If a guarantor could settle for less than the full amount, would the amount paid by a guarantor would reduce the amount of debt cancelled?

Can I "Check the Box" to convert a pass-through LLC to a C-Corp taxed LLC?

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IRS Closes the Loop Hole for Most Settlements

Before 1996, personal damages were not taxable, including damages for emotional distress, defamation, and the like.

But in 1996, that window was all but closed, except for certain limited exceptions, such as settlements for physical injuries and certain property damage. (See Small Business Jobs Protection Act, 8/21/96, amending IRC sec. 104(a)(2)).

Related legal fees are also included in income, unless the claims are employment claims, certain whistleblower claims or related to a trade or business. Tax Cuts and Jobs Act, P.L. 115-97.

Specifically, the IRS passed a rule change that implemented a "origin of the claim" test. Under this test, if the origin of the claim is considered "income" (i.e., for unpaid wages) the resulting settlement for that claim will be considered taxable income, too.

Now, outside of recoveries for physical injuries and certain property damage, settlements and recoveries will generally considered gross income and taxed.

And, in 2017, Congress passed a tax bill (TCJA) that generally eliminated any deduction for legal fees for sexual harassment employment cases. So not only will a settlement or recovery likely be taxed, but there will be no deduction allowed for the attorney's fees and expenses incurred in obtaining that settlement.

The result is that defendants may issue you a Form 1099.

Audience Questions

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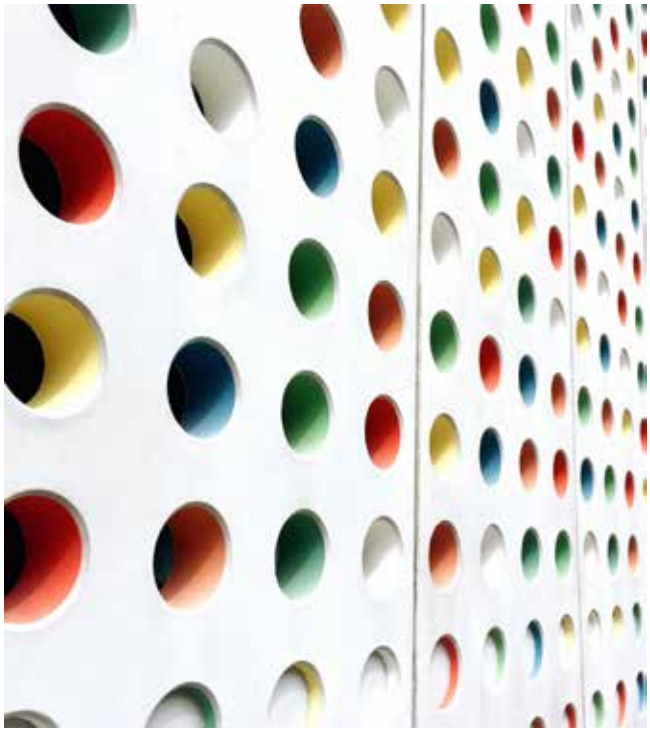

THANK YOU FOR ATTENDING

Cancellation of Debt Income

RICHARD CARMODY

FRANKLIND LEA

VIRGINIA TATE

JACK WILLIAMS

Additional Materials / Examples

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Example – Typical Commercial Foreclosure

Rachel fufills his dream of owning a "Buy Here, Pay Here" automobile dealership. He purchases used vehicles for inventory which act as security for the dealership's recourse credit company financing. Wisely, Rachel's business is structured as a C-Corporation. Rachel does not guarantee the debt.

Rachel's business fails with $5,000,000 of auto inventory, $4,500,000 of debt, and $500,000 of her cash equity (his stock investment in the C-Corp.) While the (accounting) book value of the inventory was $5,000,000, the market value of the vehicles was only $4,000,000.

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Example – Typical Comm'l Foreclosure (Cont'd)

FACTS

Rachel fulfills his dream of owning a "Buy Here, Pay Here" automobile dealership. She purchases used vehicles for inventory which act as security for the dealership's recourse credit company financing. Wisely, Rachel's business is structured as a C-Corporation. Rachel's business fails with $5,000,000 of auto inventory, $4,500,000 of debt, and $500,000 of his Rachel's cash equity (his stock investment in the C-Corp.) While the (accounting) book value of the inventory was $5,000,000, the market value of the vehicles was only $4,000,000.

ANSWER - KEY POINTS

Recourse Loan (to dealership), Borrower does not retain property, not residential, no guarantee

	Gain(Loss)	COD Income
Recourse Debt		
Basis		
Fair Market Value		

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Example – Typical Comm'l Foreclosure (Cont'd)

DETAILED ANSWER

Rachel experienced a net loss of

Rachel experienced a COD income of $

The debt was recourse, not a residential property

Rache also qu

ANSWER - KEY POINTS

Non-Recourse Loan, Borrower does not retain property, C-Corporation,

	Gain(Loss)	COD Income
Recourse Debt		$450,000
Basis	$500,000	
Fair Market Value	$350,000	$350,000
	-$150,000	$100,000

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Adjustment of Tax Basis

Key Code, Cases & Regulations

Form 982 : Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

https://www.irs.gov/pub/irs-pdf/f982.pdf

THE PROBLEM

3 issues

Entity Selection – Ginny (Check the box, name with partnership in it)

Basis and NOL - Jack

Guarantor issue - Richard

.

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American Bankruptcy Institute

Virtual Annual Spring Meeting

Cancellation of Debt Income: A Ticking Time Bomb?

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I. INTRODUCTION

"Taxes," as Justice Holmes informed us long ago, "are what we pay for civilized society."[1] It may surprise many that this price is extracted even from individuals in bankruptcy. Although the right to discharge in bankruptcy ensures an "honest but unfortunate debtor" a fresh start to begin anew his or her economic life, that right is tempered by the government's legitimate interest in protecting the public fisc by collecting taxes. The balance struck by the Bankruptcy Code[2] and Internal Revenue Code[3] between the competing interests of an individual debtor and the federal government insulates specific tax claims from the bankruptcy discharge. Under this compromise, only enumerated tax claims will survive a bankruptcy discharge in an individual debtor's bankruptcy 11 case.[4]

Recognizing that nondischargeable tax liabilities are inconsistent with the fresh start policy, Congress further attempted to alleviate some harshness through enactment of the Bankruptcy Tax Act of 1980 ("BTA").[5] Among other things, the BTA creates a separate taxable entity where an individual files for relief under either chapter 7 or 11 of the BC[6] 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 taxes to the estate as a BC section 507(a)(8) priority claim.[7] Nevertheless, certain tax claims designated as nondischargeable under BC section 523(a)(1) (such as claims for

[1] *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927)(dissenting opinion).
[2] 11 U.S.C. § 101 *et seq*. In these materials, the Bankruptcy Code is also referred to as "BC."
[3] Title 26, United States Code. In these materials, the Internal Revenue Code is also referred to as "IRC."
[4] 11 U.S.C. § 523(a)(1)(identifying those tax claims that are nondischargeable by an individual debtor in a chapter 7 or 11 case).
[5] Pub. L. No. 96-589, 94 Stat. 3389 (1980)(codified at several sections of the IRC).
[6] *See* IRC § 1398. No separate entity for tax purposes is created where a partnership or corporation files for bankruptcy relief. IRC § 1399.
[7] *See* IRC § 1398(d)(2).

taxes incurred within three years of the bankruptcy petition date) survive the discharge and, thus, significantly affect a debtor's fresh start.

The outline begins with a discussion of the rules regarding the treatment of cancellation of indebtedness ("COD") income both in and out of financial distress. A careful assessment of the application, limitations, and exclusions of IRC section 108 are explored with examples delineating key concepts and missteps in areas of insolvency, bankruptcy, and qualified principal residence indebtedness. The outline then turns to a discussion of the tax issues generated by mortgage modifications and foreclosures, a common occurrence with individual taxpayers who happen to own homes either as their primary residence or as an investment or second home. Additionally, the outline focuses on the separate entity rules for individuals who file for relief under chapter 7 or 11 of the BC. Finally, the outline considers the rules regarding the priority and dischargeability of tax claims, carefully distinguishing between the tax relief a debtor could expect in a chapter 7 or 11 case as opposed to a chapter 13 case. Each nondischargeable tax claim will be addressed with particular attention to the recurring issues that one confronts in an individual debtor bankruptcy practice. The materials will conclude with several practice pointers that blend both substantive bankruptcy tax law with bankruptcy procedure.

The materials will introduce the reader to nine principles that every bankruptcy practitioner must know. These nine principles are:

1. Identifying the tax claim. The taxing authority may have a claim based on gain and/or COD income, for example, where property owned by the taxpayer is foreclosed on and any deficiency released by the creditor. Generally, gross income includes gain from property and COD. IRC section 61(a).
2. Identifying the taxpayer. For taxes, the debtor is the taxpayer except where IRC section 1398 applies and changes the general rule.
3. Not all taxes are nondischargeable.[8]

[8] *See* IRC § 523(a).

4. Secured tax claims – even those securing nondischargeable tax claims – are recognized in bankruptcy and largely protected from various avoidance powers attacks.
5. Looking back from the petition date, what returns were last due (including extensions) within the last three years? Personal taxes are dischargeable if the tax year in question is more than three years prior to the filing of the bankruptcy case unless some other provision applies.
6. Have any taxes been assessed within 240 days preceding the petition date? Personal taxes are dischargeable if the tax in question has been assessed more than 240 days prior to the filing of the bankruptcy case unless some other provision applies.
7. Are any returns still under audit or at audit risk (not including those that involve fraudulent returns, etc.), before the tax court, or under open assessment? Claims associated with such returns are both priority and nondischargeable.
8. Are there any late filed returns or years in which no return was filed? Personal taxes are dischargeable if the tax return for the year in question was filed at least more than two years prior to the bankruptcy filing.
9. Are there any taxes that arise from the filing of fraudulent returns or willful attempts to evade or defeat a tax (with no time limit)?

II. COD SCENARIOS

Federal tax issues often arise in the course of contemplating a variety of responses to too much debt. For example, the release of credit card debt by a credit card company, the write down of indebtedness often to the fair market value of any collateral like a home mortgage, and the transfer of property in complete or partial satisfaction of indebtedness are all potential triggering tax events that may generate COD income or gain (or loss).

A. RELEASE OF DEBT

Example 1: ***Release:*** Taxpayer can no longer pay his debt. Finance Company agrees to release $500 of debt for payment of $100. Taxpayer must recognize $400 as COD income.

B. WRITE DOWN OF RECOURSE AND NONRECOURSE INDEBTEDNESS

Example 2: ***COD Income Generated By Write-Down of Debt (Recourse or Nonrecourse)*****:** Taxpayer borrows $500 from Lender, agreeing to pay Lender $500 in one year. To secure repayment of the indebtedness, Taxpayer grants a security interest in property valued at $500. When the indebtedness becomes due, Lender agrees to write down the debt to $400, the present fair market value of the collateral. Taxpayer would recognize $100 of COD income.

C. TRANSFER OF PROPERTY IN SATISFACTION OF INDEBTEDNESS

Example 3: ***Property in Satisfaction of Indebtedness***: Taxpayer owes Lender $500, secured by an office building valued at $300. The debt is recourse. If Taxpayer transfers the property to Lender through a deed in lieu or a foreclosure in exchange for complete forgiveness of the indebtedness, Taxpayer will recognize $200 in COD income. (*COD Income = Indebtedness - Fair Market Value of Collateral*).

With these potential tax events in mind, we begin our discussion of the tax ramifications of discharge of indebtedness in financial distress. Special care and attention will be given to how these tax rules apply in the context of individual debtor bankruptcy cases.

III. COD INCOME METHODOLOGY

Some of the most difficult issues in the law are posed by the release or restructuring of indebtedness coupled with the filing of a bankruptcy petition. Beyond the traditional state and bankruptcy law implications, difficult tax issues regularly challenge even the expert in the field. As an aid to identifying and addressing the potential tax issues, I suggest a methodology that is helpful in most situations.

The methodology I suggest rests on four related but distinct levels or orders of inquiry. Tax issues can be quite complex. By adhering to a sophisticated but simple plan of attack, one can quickly zero in on the actual issues posed by the restructuring and the range of solutions available.

The ***first order*** inquiries involve the following:

1. ***Has an event taken place that could potentially give rise to COD income or gain?*** Here, one would determine whether there has been a write down of indebtedness, partial or complete forgiveness of debt, a material modification of the indebtedness, a direct or indirect acquisition of debt by a related party, a transfer of property in satisfaction of debt, or some other sale or exchange.

2. ***Is there either a case law or statutory rule of nonrealization that may apply?*** Here, the case law and statutory rules of exception include the gifts exception, the indebtedness subject to bona fide dispute exception, lost deduction exception, purchase price adjustment exception, contribution of capital exception, stock-for-debt exception, and partnership equity-for-debt exception.

3. ***When, if at all, must the COD income or gain be realized?*** Here, the rules on when COD income occurs are muddled. Under state law, one should generally look to some objective act that evidences a partial or complete discharge, material modification, etc., of indebtedness. If the discharge allegedly occurs in bankruptcy, one must isolate a bankruptcy court order discharging the indebtedness.

The ***second order*** inquiry includes:

> ***Assuming a taxpayer must realize COD income, is there a rule of nonrecognition that may apply?*** The rules of nonrecognition embodied in IRC §108 that are generally relevant to restructurings include the (i) bankruptcy exception; (ii) insolvency exception; (iii) qualified farm indebtedness exception; (iv) qualified real property indebtedness exception; and (v) qualified principal residence indebtedness

forgiveness occurring between January 1, 2007, to January 1, 2015 (tax years 2007-2014) .

The ***third order*** inquiry includes:

> ***Assuming either the insolvency or bankruptcy rule of nonrecognition applies, should you reduce tax attributes as identified in section 108(b) or elect to reduce basis in depreciable assets or employ a strategy that uses a combination of the two approaches?*** Here, one must decide whether a taxpayer receives a greater benefit by electing to reduce basis in depreciable property or by simply reducing tax attributes in accordance with IRC §108(b), or embrace an approach that uses a combination of the two alternatives in an effort to minimize potential tax liabilities while preserving tax attributes. For those situations where the qualified principal residence indebtedness rule applies, the taxpayer must reduce the basis in his principal residence (if the taxpayer still owns the main home) by the amount not recognized but to no less than zero.[9]

The ***fourth order*** inquiries include:

1. ***Has the filing of a petition in bankruptcy changed the taxpayer, that is, changed who is liable for the tax?*** Here, one must determine whether the separate entity rules under IRC §1398 apply. If so, the bankruptcy estate is a separate taxpayer, with the duty to report, account for, and pay any tax due.

2. ***Assuming that IRC §1398 does apply, should you make the section 1398(d)(2) election?*** The election allows a debtor to bifurcate the tax year, often to the benefit of a debtor by converting what would otherwise be a nondischargeable postpetition obligation into a prepetition priority claim against the estate.

[9] IRS Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*. An individual taxpayer would enter the amount of the basis reduction on line 10b of IRS Form 982. For details regarding basis of a main home, see IRS Publication 523.

IV. OVERVIEW OF COD INCOME

The savings realized by a taxpayer from the material modification, reduction, or total discharge of a bona fide debt may be income for tax purposes.[10] The Supreme Court established this principle in *United States v. Kirby Lumber Co.*[11] In *Kirby,* the corporate taxpayer purchased its own bonds at a discount on the open market. The Court held that the taxpayer realized income to the extent the issue price for the bonds exceeded the price paid for the reacquisition of those bonds.[12] Section 61(a)(12) of the IRC provides that gross income includes "income from the discharge of indebtedness.[13] While neither the IRC nor Treasury regulations provide any further definition of what constitutes COD income, case law has provided that COD income may result from complete or partial forgiveness of indebtedness,[14] the modification of the terms of indebtedness,[15] or the foreclosure of property subject to recourse debt.[16] Generally, upon

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[10] *See United States v. Kirby Lumber Co.*, 284 U.S. 1, 2-3 (1931) (finding gross income where taxpayer bought back some of its own bonds at lower price than that at which bonds were issued). For a more detailed discussion of the treatment of COD income, see Paul H. Asofsky, *Discharge Indebtedness Income in Bankruptcy After the Bankruptcy Tax Act of 1980,* 27 ST. LOUIS U. L.J. 583 (1983); Boris I. Bittker & Barton H. Thompson, Jr., *Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber* Co., 66 CAL. L. REV. 1159 (1978); Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness,* 10 VA. TAX. REV. 1 (1990).

[11] 284 U.S. 1 (1931).

[12] *Id.* at 3. The Supreme Court explained:

> As a result of its dealings [the taxpayer] made available $137,531.30 [in] assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The... [taxpayer] has realized within the year an accession to income, if we take the words in their plain popular meaning, as they should be taken here. (Citations omitted).

[13] IRC § 61(a)(12).

[14] *See Commissioner v. Jacobson*, 336 U.S. 28, 38-40 & n.7 (1949) (holding repurchase of secured bonds at prices below that at which they were sold generated gain attributable to taxpayer's income).

[15] *See Stackhouse v. United States*, 441 F.2d 465, 469 (5th Cir. 1971) (stating modification of partnership's debt is considered a pro rata distribution of money to each partner, creating income to partners individually). *But see* IRC § 108(e)(5). Under §108(e)(5), the modification of a purchase-money debt will not produce income where the reduction does not occur in a title 11 case or when the taxpayer is insolvent. *Id.*

[16] Rev. Rul. 90-16, 1990-1 C.B. 12, 13.

discharge of indebtedness, a taxpayer realizes income in an amount equal to the difference between the amount due on the obligation and the amount paid for the obligation's discharge.[17]

> **Example 4:** Debtor borrows $500 from Lender, to be repaid one year from the loan. Lender subsequently cancels the debt after unsuccessfully attempting to recover. The original transaction would have no tax significance since the loan benefits to Debtor would be offset by the obligation to repay. If the obligation is removed, Debtor theoretically benefits from the "freeing up" of assets. This "benefit" is taxable. A more elegant way in which to view the situation is through the lens of the tax benefit rule.[18] In Year 1, the loan had no tax significance because the accession in wealth was tempered by a corresponding liability. Thus, the transaction is a "tax wash." However, in Year 1+X, an event takes place that makes the manner in which you treated the original transaction in Year 1 no longer valid. The event, of course, is the forgiveness of the indebtedness. Thus, the tax benefit rule requires that the taxpayer make the necessary adjustments in Year 1+X to reflect the realities of the present situation.

Before enactment of the BTA,[19] the general rule was that debt discharge resulted in the realization of income to the extent of the amount discharged.[20] However, exceptions to this general rule evolved through case law, including the (1) gift exception, (2) bona fide debt exception, (3) stock-for-debt exception,[21] (4) contribution of capital exception,[22] and (4) purchase price adjustment exception.[23] Furthermore, debt forgiven in a bankruptcy proceeding and debtors who were insolvent both before and after the debt forgiveness also qualified for a limited exception to the general rule requiring the realization of COD income.[24] Finally, corporations and certain

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[17] Different rules apply where obligations have been issued at a discount. *See* IRC §108(e)(3); *see also* William Tatlock, *Discharge of Indebtedness, Bankruptcy and Insolvency,* Tax Mgmt. (BNA) No. 466-2d, at A-9.

[18] *See* Alice Cunningham, *Payment of Debt with Property--The Two Step Analysis After Commissioner v. Tufts*, 38 TAX LAW. 575, 599-605 (1985)

[19] Pub. L. No. 96-589, 94 Stat. 3389.

[20] *See* IRC § 61(a)(12). An in-depth treatment of the prior law governing discharge of indebtedness appears in C. RICHARD MCQUEEN & JACK F. WILLIAMS, FEDERAL TAX CONSEQUENCES OF BANKRUPTCY LAW AND PRACTICE §23.01 (3d ed. 2020).

[21] McQUEEN & WILLIAMS, *supra*, § 21.16.

[22] *Id.* § 21.15.

[23] *Id.* § 21.14.

[24] Treas. Reg. § 1.61-12(b)(1) (as amended in 1980). *See Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95, 96 (5th Cir. 1934) (finding no income where cancellation of past due debt does not have effect of increasing asset's value); *F.W. Sickles Co. v. United States*, 31 F. Supp. 654, 656 (Ct. Cl. 1940) (noting

non-corporate taxpayers, to the extent solvent after debt forgiveness, could avoid income recognition by making an election under IRC section 108 and consenting to a reduction of basis in assets, depreciable and non-depreciable, under IRC section 1017.[25]

A number of problems existed under prior law regarding treatment of COD income. For instance, a debtor who elected to avoid recognizing COD income by reducing basis in property under IRC section 1017, could effectively convert what otherwise would have been ordinary income into capital gain upon selling those assets with a reduced basis. In some instances, certain nondepreciable assets, such as land or stock of a subsidiary corporation, might never be sold in the normal course of business. This resulted in the total avoidance of a tax liability, rather than mere deferral of the tax.[26]

A. COD INCOME UNDER IRC SECTION 108

Under IRC section 108, a taxpayer's gross income shall not include amounts realized from the discharge of indebtedness when:

(1) the discharge occurs in a title 11 case;[27]

(2) the debtor is insolvent immediately before the discharge;[28]

(3) the indebtedness is considered "qualified farm indebtedness;"[29]

---

insolvent taxpayer has no income generated from discharge of indebtedness).

[25] *See* McQUEEN & WILLIAMS, *supra*, § 23.11.

[26] H.R. REP. No. 833, 96th Cong., 2d Sess. 9 (1980); S. REP. NO. 1035, 96th Cong., 2d Sess. 9-10 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7025 (noting possibility that taxpayer might take reduction in basis in property which would never be sold).

[27] IRC §108(a)(1)(A). Thus, it is imperative that any COD occur pursuant to a court order or confirmed plan. Michael G. Frankel, *Tax Planning for Troubled Real Estate and Partnership Transactions-Part I,* 19 J. REAL EST. TAX'N 285, 290 (1992). The BTA defines a title 11 case as a federal bankruptcy case brought under title 11. *See* IRC §108(d)(2). In addition, the taxpayer must be under the court's jurisdiction, and the discharge must be either granted by the court or pursuant to a court-approved plan.

[28] IRC § 108(a)(l)(B). The Bankruptcy Tax Act of 1980 states that other than those exceptions specifically provided in IRC § 108(e), there is no other insolvency exception to the rule that gross income includes debt discharge income. *Id.* § 108(e)(1).

[29] *Id.* § 108(a)(1)(C).

(4) the indebtedness is considered "qualified real property indebtedness;[30] or

(5) the indebtedness is considered qualified principal residence indebtedness that is discharged before January 1, 2021. [31]

Furthermore, title 11 debtors, insolvent taxpayers, and taxpayers with qualified farm indebtedness are given a choice of tax consequences to provide broader flexibility and a more robust fresh start. In accordance with IRC § 108 and 1017, taxpayers may apply the amount of COD income against certain statutorily delineated tax attributes, such as net operating losses and carryovers,[32] or elect to apply any portion of COD to reduce the basis of "depreciable property" or a combination of both.[33] This choice allows taxpayers the flexibility of accounting for COD income in a manner most favorable to their own tax positions.[34]

B. COD ISSUES UNRESOLVED BY IRC SECTION 108

Although IRC section 108 defines some of its operative terms, several omissions are noteworthy and deserve reconsideration. Interestingly, several of the more important practical issues are not addressed by the BTA.

(1) Has an event triggering cancellation of indebtedness income occurred?

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30 *Id.* § 108(a)(1)(D). The insolvency exclusion takes precedence over the qualified farm or real property indebtedness exclusions (but not the qualified principal residence exclusion unless a taxpayer elects otherwise), and the title 11 bankruptcy exclusion takes precedence over all others. *Id.* § 108(a)(2).

31 *Id.* § 108(a)(1)(E) and (h). There are also special provisions with regard to the forgiveness of certain student loans in specific situations in this section.

32 *Id.* § 108(b). Provision is made for the potential reduction of certain tax attributes and the order in which they may be reduced is set out. *Id.* § 108(b)(2)(A)-(G).

33 *Id.* § 108(b)(5).

34 For example, it would be advantageous for a taxpayer to reduce net operating losses where it believes that they will end up being "wasted" due to lack of income. S REP. NO. 1035, reprinted in 1980 U.S.C.C.A.N. at 7025. However, where a taxpayer expects to have income which could be offset by net operating losses, the taxpayer may also reduce basis in property. *Id.*

Section 108 fails to provide a working definition of the term *discharge of indebtedness*. Consequently, courts will continue to bear the responsibility of developing a definition through the interstitial growth of case law.[35] The American Bar Association Section of Taxation has proposed a good working model of discharge of indebtedness. In the Report of the Section 108 Real Estate and Partnership Task Force,[36] the Section suggests as a starting point the following two-part test: (1) whether at the inception of the loan transaction, the borrowed funds were excluded from the taxpayer's income upon receipt because of the offsetting obligation to repay; and (2) if so, whether the taxpayer's obligation to repay has been canceled, forgiven, or reduced.[37] Nonetheless, a taxpayer might argue that section 108 is not applicable, by citing a judicial exception to the general rule of COD income. For example, under prior case law no COD income was realized when the cancellation of a debt was intended as a gift[38] or the cancellation was of a disputed debt.[39] The failure of IRC section 108 to provide a precise definition of *discharge of indebtedness* should not affect this conclusion.

The IRC describes *indebtedness of the taxpayer as* inclusive of two distinct types of indebtedness: (1) debts for which a taxpayer is personally liable; and (2) debts on property owned

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[35] *See United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931) (repurchase of corporate bonds by corporation for less than par value constitutes discharge of indebtedness); *Commissioner v. Sherman*, 135 F.2d 68, 70 (6th Cir. 1948) (no gain in income where mortgage bank accepted partial payment and where effect of transaction was a reduction in purchase price of property); *Colonial Savings Ass'n. v. Commissioner*, 85 T.C. 855, 861 (1985), *cert. denied*, 489 U.S. 1090 (1989) (penalties for premature withdrawal of savings certificates do not give rise to income from discharge of indebtedness); *Edmont Hotel Co. v. Commissioner*, 10 T.C. 260, 263 (1948) (taxable income realized in acquiring own bonds at less than face value).

[36] American Bar Association Section of *Taxation, Report of the Section 108 Real Estate and Partnership Task Force, Part 1*, 46 TAX LAW. 209 (1992) [hereinafter *ABA Report Part I*]; American Bar Association Section of Taxation, *Report of the Section 108 Real Estate and Partnership Task Force, Part II,* 46 TAX LAW. 397 (1993) [hereinafter *ABA Report Part II*].

[37] *ABA Report Part I*, *supra*, at 224.

[38] Tatlock, *supra*, at A-14.

[39] McQUEEN & WILLIAMS, *supra*, § 20.18.

by a taxpayer, such as a mortgage on real estate owned by the taxpayer.[40] Thus, discharges of both recourse and nonrecourse debts of a taxpayer are subject to section 108.[41]

> **Example 5:** Taxpayer owes a $1.5 million recourse debt, secured by an office complex valued at $1.0 million. If Lender agrees to write down the debt as part of a restructuring to the fair market value of the collateral, Taxpayer will realize COD income of $500,000.
>
> **Example 6:** Same facts as above except that the indebtedness is nonrecourse. Taxpayer will realize COD income of $500,000.[42]

(2) When was the cancellation of indebtedness income realized?

Section 108 does not address the issue of *when* COD income is realized. The precise answer turns on whether the COD occurs in or out of bankruptcy. Outside of bankruptcy, the ABA Tax Section has suggested the following test:

> As a general rule, a debt is discharged upon the earlier to occur of: (1) forgiveness by agreement of the parties; (2) cancellation by a binding act of the creditor or by operation of applicable law (such as in certain cases the running of the statute of limitations); or (3) a creditor's acceptance of payment of an amount less than the issue price of the debt (less any principal amounts previously repaid) in complete satisfaction thereof.[43]

In bankruptcy, the timing of the event of discharge is even more muddled. The ABA would tie discharge of indebtedness to bankruptcy discharge under sections 727, 1141(d) or 1328.[44] However, where a creditor "enters into a binding agreement (generally pursuant to court order)" to forgive all or part of a debt before the discharge event, then COD income is realized at that point.[45] This is a sensible approach. Assuming the debt is dischargeable, the entry of a discharge

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[40] IRC §108(d)(1).
[41] *See* Rev. Rul. 91-31, 1991-1 C.B. 19. "The reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt ... results in the realization of discharge of indebtedness income ...." *Id.* at 20. *See generally* Tatlock, *supra*, at A-13 to A-14.
[42] *See* Rev. Rul. 91-31.
[43] ABA *Report Part I, supra*, at 228.
[44] *Id.*
[45] *Id.* at 228-29.

order is the latest possible moment for the realization of COD income. Likewise, because of the requirement that a compromise or settlement involving the debtor or estate must be approved,[46] the court order approving the settlement is also a sensible point for realizing COD income. Since no discharge results from Chapter 7 cases involving partnerships or corporations or liquidations under Chapter 11, similar indicators, such as a final settlement of the affairs of the debtor entity should be used to determine when COD income occurs in such cases.[47]

C. COD ISSUES UNDER THE CARES ACT OF 2020

A number of COD issues appear to be generated by enactment of the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"). The CARES Act modifies several tax provisions in the IRC to provide relief to businesses and individuals from the economic effects of the COVID-19 crisis. For example, section 1106 of the CARES Act provides that loans forgiven under the Paycheck Protection Program ("PPP") do not result in COD income as long as such loans are actually used for payroll and other qualifying expenses. Congress intended that the PPP provide employers with the resources necessary to keep employees on the payroll and the business operating. If the business complies with the terms of the loan, a loan amount of up to eight weeks of eligible expenses can be forgiven. Section 1106 of the CARES Act explicitly excludes the amount of the PPP loan that is forgiven from the employer's income.[48]

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[46] BANKR. R. 9019.

[47] *See generally,* Tatlock, *supra*, at A-12(1) to (2) (noting that COD income is realized when it is clear that debt will not be paid).

[48] Although the CARES Act is silent on the deductibility of expenses paid with loan proceeds that are forgiven, the Service has taken the position in Notice 2020-32 that such costs are not deductible, relying on IRC section 265 to prohibit deductions for payroll and other expenses financed by PPP loans to the extent that such loans are forgiven. "The IRS position has proven to be controversial. Many expected that in keeping with the policy of PPP to provide liquidity for businesses a deduction for the expenses would be allowed, even though it would effectively provide a double benefit by allowing a deduction for income that was not taxed. House Ways and Means Committee Chairman Richard Neal (D-MA) stated that he hopes such deductions will be made permissible in the next round of COVID-19 response legislation. Trade associations and other stakeholders also are weighing in with the Treasury Department and

The CARES Act is silent on how PPP loan forgiveness interrelates with the tax attribute reduction provisions in section 108(b).

> Because the CARES Act does not modify section 108, it appears that the loan forgiveness provisions of Section 1106 of the CARES Act may not result in a reduction of available NOLs under Code Section 108(b)(2). For this reason, PPP debt forgiven under the CARES Act may not reduce the available benefit from the provisions in the CARES Act that extend the availability of NOL carrybacks and suspend the 80 percent NOL limit. Income resulting from canceled debt as delineated in Code Section 108(b) would continue to reduce other tax attributes. Again, without legislative history, subsequent Treasury Department guidance, or legislative action, it is unclear how these provisions are intended to work together, and as currently drafted, the loan forgiveness provisions do not squarely fit within the attribute reduction rules of Code Section 108.[49]

D. BANKRUPTCY EXCEPTION TO THE RECOGNITION OF COD INCOME

As previously discussed, a taxpayer need not recognize COD income if the discharge of debt occurs in a title 11 case.[50] Specifically, a taxpayer must be under the bankruptcy jurisdiction of a court at the time the COD occurs. Additionally, the debt discharge must occur pursuant to court order or a plan approved by the court.[51] Thus, it is important to ensure that a bankruptcy court order or a confirmation order approving a plan of reorganization specifically reference the discharge of indebtedness.[52]

Assuming the bankruptcy exception in IRC §108(a)(1)(A) applies, the method of deferment is similar to that for the insolvency exception. A taxpayer must (1) reduce tax attributes

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Congress to urge them to reconsider this policy. However, Treasury Secretary Mnuchin has stated that "you can't double dip." Notice 2020-32 remains controlling at this time, but taxpayers will want to monitor this situation closely going forward in case a change is made legislatively or administratively." K&L Gates Hub, https://www.klgates.com/covid-19-tax-implications-of-paycheck-protection-loan-forgiveness-04-29-2020,

[49] K&L Gates Hub, https://www.klgates.com/covid-19-tax-implications-of-paycheck-protection-loan-forgiveness-04-29-2020,

[50] IRC § 108(a)(1)(A).

[51] IRC § 108(d)(2).

[52] *See* Stern, *supra*, at A-8(1).

in the order delineated in 108(b), (2) elect to reduce basis in depreciable property pursuant to section 108(b)(5), or (3) employ a combination of the two approaches. However, unlike the insolvency exception, the bankruptcy exception is not limited to the extent a taxpayer is insolvent. Thus, close calls on insolvency generally lead one to seek the relative comfort of certainty that bankruptcy provides for taxpayers with large amounts of potential COD income.

In sum, title 11 debtors and insolvent taxpayers are given a choice of tax consequences to provide broader flexibility and a more robust fresh start. In accordance with IRC sections 108 and 1017, taxpayers may apply the amount of COD income against certain statutorily delineated tax attributes, such as net operating losses and carryovers,[53] or elect to apply any portion of COD to reduce the basis of "depreciable property" or a combination of both.[54] This choice allows debtors the flexibility of accounting for COD income in a manner most favorable to their own tax positions.[55] However, to prevent the conversion of ordinary income associated with COD income into capital gain through an election to reduce basis, the BTA also provides that gains realized from the sale of assets with a reduced basis are subject to recapture of the amount of COD income as ordinary income and not as a capital gain.[56]

> **Example 7:** Debtor has total debts of $300,000 and total assets with a fair market value of $275,000. Lender cancels a $100,000 debt. Assuming the debt discharge occurs pursuant to a bankruptcy court order after Debtor had filed its petition in bankruptcy, the entire $100,000 of COD income is deferred and need not be recognized upon discharge. Of course, Debtor may have to reduce certain tax attributes in accordance with IRC §

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[53] *Id.* § 108(b). Provision is made for the potential reduction of the enumerated tax attributes and the order in which they may be reduced is set out. *Id.* § 108(b)(2)(A)-(G).

[54] *Id.* § 108(b)(5).

[55] H.R. REP. No. 833, *supra*, at 8-9; S. REP. No. 1035, *supra*, at 9-10, *reprinted in* 1980 U.S.C.C.A.N. at 7025. For example, it would be advantageous for a taxpayer to reduce net operating losses where he believes that they will end up being "wasted" due to lack of income. S REP. NO. 1035, *supra,* at 10, reprinted in 1980 U.S.C.C.A.N. at 7025. However, where a taxpayer expects to have income which could be offset by net operating losses, the taxpayer may also reduce basis in property. *Id.*

[56] IRC § 1017(d)(l). Subsequent dispositions of property whose basis has been reduced under § 1017 will give rise to income at ordinary rates under §§ 1245, 1250. *Id.*

108(b). Any excess COD income remaining after attributes are reduced is forever excluded from income.

E. INSOLVENCY EXCEPTION TO RECOGNITION OF COD INCOME

As previously discussed, a taxpayer need not recognize COD income to the extent the taxpayer is insolvent immediately before the discharge. However, another significant omission in section 108 is its failure to provide a meaningful definition of *insolvency.* Section 108 provides that a taxpayer is insolvent to the extent that its liabilities exceed the "fair market value" of its assets immediately before the debt discharge.[57] The IRC does not define "fair market value."[58] The IRC's traditional definition is the price at which property exchanges hands between a willing seller and a willing buyer, neither under a compulsion to act.[59] One commentator suggests that transaction costs associated with the disposition of the assets should be netted out before the calculation is made.[60] Although this approach is sensible, section 108 does not appear to support it.

Additionally, section 108 fails to consider specifically whether exempt assets should be included in the determination of insolvency.[61] Although opposed at one point, the IRS accepted this position on the exclusion of exempt assets, but has since recanted.[62] However, pre-BTA

[57] IRC §108(d)(3).

[58] Under Bankruptcy Code § 101(32), the valuation standard is "a fair valuation" and not "a fair market value."

[59] Treas. Reg. § 1.70A-1(c)(2) (as amended in 1990) (concerning charitable contributions); *Id.* § 20.2031-1(b) (as amended in 1965) (discussing valuation of property in gross testamentary estates); *id.* § 25.2512-1 (as amended in 1992) (regarding valuation of property); *see also* IRS Rev. Rul. 59-60.

[60] Robert C. Livsey, *Determining if a Taxpayer is Insolvent for Purposes of the COD Income Exclusion,* 76 J. TAX'N 224, 224 (1992).

[61] Prior to enactment of the BTA, cases held that exempt assets were not counted for insolvency purposes. *See, e.g., Cole v. Commissioner*, 42 B.T.A. 1110, 1113 (1940) (holding that equity in insurance policies is not included as asset for insolvency determination).

[62] Priv. Ltr. Rul. 91-25-010 (Mar. 19, 1991). The Ruling noted that when considering whether or not a person is insolvent, only assets that are subject to claims of taxpayer's creditors should be used to determine insolvency. *Id.* "[A] taxpayer's entitlement to the insolvency exclusion... is based on all of the assets reachable by the individual taxpayer's creditors." Priv. Ltr. Rul. 89-20-019 (Feb. 14, 1989).

authority does exist for the exclusion of assets that are not subject to the claims of creditors under local law.[63] Under this approach, from a creditor's perspective, insolvency should generally be calculated by reference to those assets that are ultimately available to a taxpayer's general creditors under state law to reduce their debts. The present IRS position is that exempt assets are included in the insolvency calculation.[64] Recent authorities, moreover, hold that the word "assets" in section 108(d)(3) includes assets exempt from the claims of creditors under state law.[65]

The determination of a taxpayer's insolvency is made "on the basis of the taxpayer's assets and liabilities immediately before the discharge."[66] Thus, where agreement is reached as to the terms of settlement of the claims, the date of actual settlement and not the date of the agreement is used for the insolvency determination.[67] Precisely when this event occurs is not always self-evident.

All of these shortcomings under the insolvency exception make the use of section 108 problematic. If one miscalculates the extent of insolvency at the time of debt discharge, there are no second chances. To the extent a taxpayer is solvent, it must recognize COD income and cannot

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[63] *See, e.g., Cole v. Commissioner*, 42 B.T.A. 1110, 1113 (1940) (holding that equity in insurance policies is not included as asset for insolvency determination)*; see also Davis v. Commissioner*, 69 T.C. 814, 833-34 (1978). The court in *Cole* explained that under New York law the equity in the insurance policies of the taxpayer were free from claims of creditors. 42 B.T.A. at 1113. The court then determined that such exempt property should not be considered when determining insolvency. *Id.* at 1113.

[64] TAM 199935002, revoking PLR 9130005.

[65] *Carlson v. Commissioner*, 116 TC 87 (2001). Gregory Stern poses an intriguing question. If property is excluded from the insolvency calculation, then is it also excluded from basis reduction under §§ 108 and 1017? Stern, *supra*, at A-7. I agree with Stern's answer that exclusion from basis reduction would be consistent with the rules applicable to the bankruptcy exclusion, where the debtor's property is protected from sale under the Bankruptcy Code and not included in the bankruptcy estate is not subject to basis reduction. *Id.* (citing IRC §1017(c)(1)). *See also Schieber v. Commissioner*, TC Memo 2017-32 (Feb. 9, 2017) (a taxpayer's interest in his employer's defined benefit pension plan under which he was entitled only to receive monthly payments is not an "asset" for purposes of determining insolvency).

[66] IRC § 108(d)(3). Note that the IRS treats preferred stock similar to a liability in making the insolvency computations. Treas. Reg. § 1.1502-19(a)(2)(ii) (as amended in 1991). I believe that preferred stock should be treated as equity and not as a liability for purposes of these discharge of indebtedness provisions.

[67] *Walker v. Commissioner*, 88 F.2d 170, 171 (5th Cir.), *cert. denied,* 302 U.S. 692 (1937).

use the tax attribute reduction rules in section 108 unless another exception applies. Consequently, risk averse folk, like most practitioners, opt for the certainty of bankruptcy, thus increasing bankruptcy filings.

V. NONREALIZATION OF COD INCOME

The BTA substantially modified prior law governing federal income tax treatment of COD income. Congress intended that the BTA effectuate sound bankruptcy and tax policy by setting forth clear rules governing transactions occurring both inside and outside of bankruptcy.[68] Congress also intended to remedy some of the problems arising under prior law, while simultaneously affording taxpayers a degree of flexibility not previously available to them.[69] Accordingly, the BTA and its amendments changed section 108 to provide that a taxpayer's gross income shall not include amounts realized from the discharge of indebtedness when: (1) the discharge occurs in a title 11 case;[70] (2) the debtor is insolvent immediately before the discharge;[71] (3) the indebtedness is considered "qualified farm indebtedness;"[72] (4) the indebtedness is considered "qualified real property indebtedness;[73] or the indebtedness is considered qualified

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[68] H.R. REP. NO. 833, *supra*, at 8; S. REP. No. 1035, *supra*, at 9-10, *reprinted in* 1980 U.S.C.C.A.N. at 7024-7025.

[69] H.R. REP. NO. 833, *supra*, at 9; S. REP. No. 1035, *supra*, at 10, *reprinted* in 1980 U.S.C.C.A.N. at 7025.

[70] IRC § 108(a)(1)(A). Thus, it is imperative that any COD occur pursuant to a court order or confirmed plan. Frankel, *supra*, at 290. The BTA defines a title 11 case as a federal bankruptcy case brought under title 11. IRC §108(d)(2). In addition, the taxpayer must be under the court's jurisdiction, and the discharge must be either granted by the court or pursuant to a court-approved plan. *Id.* The election by a solvent debtor to apply COD income against tax attributes in order to defer the tax consequences, rather than the basis of depreciable assets, is limited to situations where the debt discharge occurs in a title 11 case. This is peculiar considering that the preferential treatment accorded a "G reorganization" is available in a "title 11 or similar case," *id.* § 368(a)(l)(G), which includes receiverships, foreclosures, and similar proceedings, whether in federal or state court, *id.* § 368(a)(3)(A), as well as certain federal or state agency receivership proceedings involving financial institutions, § 368(a)(3)(D). The House and Senate Committee Reports to the BTA do not describe the rationale behind this disparity, and at least one commentator on the subject asserts there is no justification for it despite a similar difference in treatment under prior law.

[71] IRC § 108(a)(l)(B). The BTA states that other than those exceptions specifically provided in IRC § 108(e), there is no other insolvency exception to the rule that gross income includes debt discharge income. *Id.* § 108(e)(1). IRC §108 also provides special rules relating to the treatment of COD income by partnerships and Subchapter S corporations. *Id.* § 108(d)(6)-(7).

[72] *Id.* § 108(a)(1)(C). Indebtedness qualifies as "qualified farm indebtedness" if:

> such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of framing, and ... 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.

Id. § 108(g)(2)(A)-(B).

[73] *Id.* § 108(a)(1)(D). The insolvency exclusion takes precedence over the qualified farm or real property indebtedness exclusions, and the title 11 bankruptcy exclusion takes precedence over all other statutory exclusions. *Id.* § 108(a)(2).

personal residence indebtedness where the discharge occurs between 2007-2014.[74] In addition, there is no indication in the legislative history that Congress intended to reject either the (1) gift exception or the (2) bona fide debt exception to the realization of COD income.

As discussed in previous sections, both case law and the BTA have identified numerous exceptions to the realization of COD income. These exceptions include the following:

i. Gifts exception
ii. Indebtedness subject to bona fide dispute exception
iii. Lost deduction exception
iv. Purchase price adjustment
v. Contribution of capital exception
vi. Stock-for-debt exception
vii. Partnership equity-for-debt exception

Because many of these exceptions were fashioned from case law and predate the enactment of the BTA, a recurring question is whether the codification of a form of the exception effectively repeals all other variations of the exception. I say no. First, the legislative history to the BTA does not suggest that the codification of, for example, the purchase price adjustment repealed all variations that existed under case law. To the contrary, sufficient statements in the legislative history suggest that to the extent not inconsistent with specific provisions in section 108, case law variations of the exceptions retain their vitality. Second, treating the codification of the exceptions as "safe-harbors" does not disturb the overall purposes of section 108. Third, recognizing the exceptions effectuates sound bankruptcy and tax policy.[75]

[74] *Id.* § 108(a)(1)(D).

[75] For a persuasive discussion on the continued viability of judicial-crafted exceptions to the realization of COD income, particularly in the context of purchase price adjustments, see Stern, *supra*, at A-6.

A. GIFTS EXCEPTION

Under case law existing prior to enactment of the BTA, no COD income was realized when the cancellation of a debt was intended as a gift.[76] Although essentially nonexistent in the business context, the gifts exception does have application in limited situations.

> **Example 8:** A owes B, her sister, $100. B forgives the debt, characterizing the transaction (or any part thereof) as a gift. If a bona fide gift is intended, no COD income is realized by A.

Interestingly, although the result that no COD income is realized is sensible, the result must be reached outside the statutory language in IRC §108. There is no statutory gift exception or meaningful definition of *discharge of indebtedness* that would shed light on the existence of the exception. One must leave the confines of the statute to reach what all would agree to be a rational result. Thus, the failure of IRC §108 to provide a precise definition of *discharge of indebtedness* should not affect the conclusion that no COD income is realized even though the original transaction was a loan.

B. INDEBTEDNESS SUBJECT TO BONA FIDE DISPUTE EXCEPTION

Under prior case law, no COD income was realized when the cancellation of indebtedness was a result of a bona fide disputed debt.[77]

> **Example 9:** Taxpayer and Plumber engage in a bona fide dispute over the cost of certain repairs. Plumber claims the cost of repairs totaled $5000. Taxpayer disagrees, asserting a total of $3000. If the parties settle the dispute at $4000, Taxpayer has not generated $1000 of COD income.

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[76] Tatlock, s*upra*, at A-14. For an extended discussion of the gifts exception, see McQueen and Williams, *supra*.
[77] McQUEEN & WILLIAMS, *supra*, § 20.18.

Notice that, like the gifts exception, there is no statutory bona fide debt exception or meaningful definition of *discharge of indebtedness* that would resolve the controversy. Again, one must leave the confines of the statute to reach what all would agree to be a rational result. Thus, the failure of IRC §108 to provide a precise definition of *discharge of indebtedness* should not affect our conclusion.

Reviewing the example given, one should notice that a bona fide dispute over the existence of the indebtedness did exist between Taxpayer and Plumber. Contrast that situation with the situation where a dispute exists between Taxpayer and Plumber as to the *collectability* of the indebtedness as opposed to its *existence*. Disputes as to collectability, regardless of the bona fides present, do not fall within the exception.[78]

Two related exceptions arise where a liability is too contingent[79] or is, in fact, an equity infusion rather than the creation of indebtedness.[80] In both situations, any discharge or satisfaction at a discount does not result in the realization of COD income.

C. LOST DEDUCTION EXCEPTION

Where the payment of a liability would give rise to a deduction such as the payment of interest on a business loan or the payment of trade payables, the discharge of that liability does not result in income realization.[81] Accordingly, no COD income will arise where, for example, a

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[78] For an extended discussion of the bona fide dispute exception, see McQueen and Williams, *supra*, at § 20.18.

[79] *See, e.g., CRC Corp. v. Commissioner*, 693 F.2d 281 (3d Cir. 1982), *cert. denied*, 426 U.S. 1106 (1983); *Zappo v. Commissioner*, 81 T.C. 77 (1983); *see also* Stern, *supra*, at A-4 - A-5.

[80] *See Stern*, *supra*, at A-5. In *Selfe v. United States*, 778 F.2d 769 (11th Cir. 1985), the court held, that notwithstanding the form of the transaction, a fact issue was generated as to whether a loan to the S corporation guaranteed by a shareholder may be recharacterized as a loan to the shareholder followed by a contribution to the S corporation. For a list of factors courts consider in determining whether an advance to an entity should be characterized as equity or debt, see *In re Lane*, 742 F.2d 1311 (11th Cir. 1984); *Mixon Est. v. United States*, 464 F.2d 394 (5th Cir. 1972).

[81] IRC §108(e)(2). *See* Albert J. Cardinali & David C. Miller, *Tax Aspects of Non-Corporate Single Asset Bankruptcies and Workouts,* 1 AM. BANKR. INST. L. REV. 87, 95 (1993) (stating COD income is not realized if discharged liability would have been deductible).

creditor of a cash basis debtor forgives a debtor's liability for unpaid interest on a business obligation.[82] Moreover, where an obligation of the partnership would give rise to a corresponding deduction when paid, no deemed distribution to the partners under IRC §752 occurs. For the most part, this exception to COD income is self-explanatory and supported by sound tax policy. The exception avoids the inconvenience of having to report COD income and an equivalent deduction on a debtor's return.[83]

The lost deduction exception, however, does not apply where an accrual taxpayer has previously taken a deduction for the amount later discharged except where the deduction did not benefit the taxpayer.[84] Thus, an accrual basis taxpayer must realize COD income from the discharge of accrued but unpaid interest, trade payables, or taxes, but only to the extent the taxpayer received tax benefits from the accruals.[85]

D. PURCHASE PRICE ADJUSTMENT

Under IRC section 108(e)(5), any purchase price debt adjustment otherwise resulting in COD income for qualified *solvent* debtors is treated as a purchase price adjustment of the property which was financed, and accordingly, does not generate COD income.[86] The effect of this exception is a reduction in the basis of the purchased property. The stated purpose of this exception is to eliminate disputes between taxpayers and the IRS concerning what debt reductions constitute

[82] Cardinali & Miller, *supra*, at 95. This is not the case if the debtor is an accrual basis taxpayer because the deduction for such interest would have already accrued prior to payment. *Id.*

[83] For an extended discussion on the lost deduction exception, see McQueen and Williams, *supra*, at §20.18.

[84] *See Retail Properties, Inc., v. Commissioner*, T.C. Memo 1964-245; *see also* Stern, *supra*, at A-12.

[85] Stern, *supra*, at A-13 - A-14.

[86] IRC §108(e)(5). "When a debt arises out of the purchase of property, the discharge may be treated as a reduction of the purchase price, rather than as income." Grant W. Newton and Gilbert D. Bloom, Bankruptcy & Insolvency Taxation 45 (2d ed. 2019).

true purchase price adjustments as opposed to COD income.[87] A pressing question is whether to allow similar treatment for title 11 and insolvent debtors as well. If allowed, taxpayers may avail themselves, in these situations, of the purchase-price exception to the realization of COD income without the requirement of reducing their tax attributes under IRC section 108(b). Possibly, expanding the exception to include insolvent and title 11 taxpayers would go even further in eliminating disputes between taxpayers and the IRS.[88]

A lingering issue is whether section 108(e)(5) completely supplants or augments the judicial purchase price adjustment. Prior to the enactment of the BTA, both the IRS and courts recognized a purchase price adjustment exception to the realization of COD income.[89] Moreover, in *Fulton Gold Corp. v. Commissioner*,[90] the court held that a discharge of nonrecourse secured indebtedness resulted in a nontaxable reduction in basis of the collateral. For the *Fulton Gold* doctrine to apply, the debtor must have retained the collateral and the debt must have been included in the basis of the property.[91] Although controversial, many commentators assert the continued vitality of the *Fulton Gold* doctrine.[92] Additionally, the IRS examined the continued existence and

[87] H.R. REP. NO. 833, *supra*, at 13, *reprinted in* 1980 U.S.C.C.A.N. at 56; S. REP. NO. 1035, *supra*, at 16, *reprinted in* 1980 U.S.C.C.A.N. at 7031.

[88] Neither IRC § 108 nor the committee reports address what should be done when the debt reduction amount exceeds the basis of the applicable property. This situation could arise, for example, when an accelerated depreciation method has been used for the purchased asset, or when the basis of the property has been adjusted downward as a result of a casualty loss. It would seem that the taxpayer would either have to recognize income despite section 108(e)(5) or else reduce the basis of the property below zero. Since a negative basis would be an anomaly in the tax law--an exception is the excess loss account in the consolidated return regulations, Treas. Reg. §1.1502-19 -- income recognition would appear to be the better result here. Such income could presumably be avoided by a qualified debtor's reduction of basis in depreciable property under section 108(a)(l)(C), (c).

[89] *See, e.g.*, Rev. Rul. 91-31, 1991-1 C.B. 19; Rev. Rul. 82-202. 1982-2 C.B. 35; *see also Commissioner v. Killian Co.*, 128 F.2d 433 (8th Cir. 1942); *Hextell v. Huston*, 28 F. Supp. 521 (S.D. Iowa 1939).

[90] 31 BTA 519 (1934).

[91] *See generally* Stern, *supra*, at A-6.

[92] *See, e.g.*, Green and Sparkman, *Consequences of Discharges of Nonrecourse Indebtedness*, 67 J. Tax'n 18 (July 1987).

application of the judicial purchase price adjustment in a Revenue Ruling.[93] Other hints exist that suggest the continued vitality of the judicial purchase price exception.[94]

E. CONTRIBUTION OF CAPITAL EXCEPTION

One of the more dramatic changes to prior law made by the BTA is the contribution-of-capital exception to the realization of COD income.[95] Before enactment of the BTA, courts held that COD income was not realized where a shareholder's debt was cancelled as a contribution of capital.[96] This was the case even where the corporate debt had been previously deducted.[97]

Section 108(e)(6)(A) significantly restricts prior law by providing that when a corporation obtains its indebtedness from a shareholder as a capital contribution, IRC § 118's tax-free treatment shall not apply.[98] A corporate taxpayer is treated as satisfying the debt by an amount of cash equal to the shareholder creditor's adjusted basis in the debt.[99] Thus, the COD rules in IRC § 108 apply only to the excess of the face amount of the obligation over the adjusted basis of the obligation in the hands of the shareholder. Treatment of this face amount will depend upon a corporate debtor's status as a title 11, insolvent, or qualified debtor.[100] While the term "contribution to capital" is not defined in the statute, the Senate Report to the BTA does indicate

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[93] Rev. Ruling 92-99, 1992-2 C.B. 35.
[94] *See, e.g., Sutphin v. United States*, 88-1 USTC &9269 (Cl. Ct. 1988).
[95] IRC §108(e)(6).
[96] *E.g., Putoma Corp. v. Commissioner*, 66 T.C. 652, 665 (1976), *aff'd, 601 F.2d 734 (5th* Cir. 1979). For a detailed discussion of the exception as it existed prior to the BTA, see MCQUEEN & WILLIAMS, *supra*, § 21.15.
[97] *Putoma,* 66 T.C. at 665-66.
[98] IRC § 108(e)(6)(A); *see* H.R. REP. NO. 833, *supra*, at 15 n.21; S. REP. NO. 1035, *supra,* at 19 n.22, *reprinted in* 1980 U.S.C.C.A.N. at 7034.
[99] IRC §108(e)(6)(B).
[100] H.R. REP. No. 833, *supra*, at 15; S. REP. No. 1035, *supra*, at 18 n.21, *reprinted in* 1980 U.S.C.C.A.N. at 7033.

that a shareholder's cancellation of debt must be related to her status as a shareholder and not to her status as a creditor attempting to recover her claim.[101]

Does the capital contribution exception apply where a partner forgives a debt to the partnership? It would appear that the answer should be yes. The consequences of recognizing the exception should turn on whether the partner forgiving the debt had been allocated all of the debt under IRC §752. If so, then it should follow that only the forgiving partner receives a deemed distribution in cash.[102] However, if the partnership debt has been allocated to all the partners, then all partners receive a deemed distribution in cash[103]

F. STOCK-FOR-DEBT EXCEPTION

One of the most controversial issues involving exceptions to the realization of COD income has been the existence and application of the stock-for-debt exception. Stock-for-debt exchanges are an historical exception to the recognition of COD income.[104] Under this exception, if a corporate debtor issued stock in exchange for debt, no COD income arose even when the stock was worth less than the debt satisfied.[105] The theory that led to the implementation of this

[101] S. REP. No. 1035, *supra*, at 19 n.22, *reprinted in* 1980 U.S.C.C.A.N. at 7034.
[102] IRC §752(b).
[103] *Id.*
[104] *See Commissioner v. Motor Mart Trust*, 156 F.2d 122, 127 (1st Cir. 1946) (holding conversion of bonds into stock was not cancellation of indebtedness); *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691,695 (1942) (recognizing stock-for-debt exchange differs from discharge of indebtedness and does not result in realization of gain), *aff'd*, 140 F.2d 382, 385 (1st Cir. 1944) (holding substitution of shares for bonds was recapitalization and not gain); Rev. Rul. 59-222, 1959-1 C.B. 80; Rev. Rul. 59-98, 1959-1 C.B. 76 (discussing exchange of stock and securities in certain reorganizations). "The cases arrived at this result under the somewhat questionable assertion that there was no satisfaction of the debt, but the issuance of the stock instead represented the creation of a new liability to substitute for the old." Asofsky, *supra*, at 600.
[105] *Motor Mart*, 156 F.2d at 127 (finding such a transaction "a form of payment for the bonds "rather than cancellation of indebtedness).

exception was that the substitution of stock for debt continued a creditor's interest in the corporate debtor.[106]

The stock-for-debt exception to COD income has been repealed by the Omnibus Budget Reconciliation Act of 1993.[107] The controversial repeal is effective for stock transferred after 1994, except for stock transferred in a title 11 or similar case that is filed before the end of 1993.[108]

[106] Mark A. Frankel, *Federal Taxation of Corporate Reorganizations,* 66 AM. BANKR. L.J. 55, 63 (1992).
[107] Pub. L. No. 103-66, § 13226(a), 107 Stat. 312, 487-88.
[108] *Id.* § 13226(a)(3).

VI. DEFERMENT OF COD INCOME: ATTRIBUTE AND BASIS REDUCTION RULES

The deferment of COD income is not cost-free. To the extent COD income is excluded under section 108(a), the COD income must be used to reduce enumerated tax attributes listed in section 108(b)(2).[109] Section 108(b)(2) lists the tax attributes to be reduced in the following order:

> (1) net operating losses for the taxable year of discharge and any net operating loss carryover;
> (2) any carryover of general business tax credits under IRC §38;
> (3) any minimum tax credits under IRC § 53(b) as of the tax year immediately following the taxable year of discharge;
> (4) any net capital-losses for the taxable year of discharge and any capital loss carryovers;
> (5) basis in all the taxpayer's property;
> (6) any passive activity loss or credit carryover under IRC §469(b) for the taxable year of discharge;
> (7) any foreign tax credit carryovers.[110]

Section 108(b)(4) contains ordering rules by which attributes are reduced. Attribute reduction is made after determining any tax for the tax year of discharge in question.[111] Carryovers reduce COD income dollar for dollar. Credits reduce COD income 33 1/3 cents for every dollar of COD income.[112] For net operating losses and capital loss carryovers, the reduction is applied first to the loss occurring during the taxable year of the discharge and subsequently to carryovers in the sequence in which such carryovers arose.[113] For credits, the reduction is applied in the order

[109] IRC § 108(b)(1); *see* Tatlock, *supra*, at A-19 to A-28(1) (discussing ramifications of attribute reduction); Stern, *supra*, at A-7 - A-8(1).
[110] IRC § 108(b)(2).
[111] IRC § 108(b)(4)(A).
[112] IRC § 108(b)(3)(B).
[113] IRC § 108(b)(4)(B).

the credits would have been applied against tax liability,[114] without regard to any income limitations on the use of the credits.[115]

Because of the forced reduction in attributes, section 108 is theoretically a rule of tax deferment and not outright exclusion. Most often, this is an illusory concept. If any COD income exists after all tax attributes in IRC §108(b) are reduced, the remaining COD income is forever excluded.[116]

Basis reduction under the tax attribute reduction rules is governed by IRC §1017. Several rules should be considered when reducing basis under IRC §108(b)(2)(E). Many of these rules are found in Treasury Regulation section 1.1017-1. First, a reduction in basis must be made in all of a taxpayer's property, both depreciable and nondepreciable property (except cash). Second, reduction in basis is made pro rata. Third, basis of property is adjusted as of the first day of the tax year following the income exclusion. Thus, if a taxpayer expects to transfer property, he or she should undertake to do so before the end of the tax year in which the COD takes place, avoiding basis reduction in the particular property. Fourth, basis of property in the hands of partners is adjusted in the case of cancellation of partnership indebtedness. Fifth, partnership interests may be treated as depreciable property and adjusted, with a corresponding adjustment of partnership property, in certain circumstances. Sixth, for individual partners who file for relief under chapter 7 or 11, the separate tax entity created under IRC §1398 makes the attribute and basis adjustments under IRC §108. Seventh, in certain circumstances, basis remaining in unadministered property, after adjustments, may pass back to the individual debtor at the close of the chapter 7 or 11

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[114] *Id.* § 108(b)(4)(C).

[115] H.R. REP. NO. 833, *supra*, at 8, S. REP. No. 1035, *supra*, at 13, *reprinted in* 1980 U.S.C.C.A.N. at 7028.

[116] *See* Kenneth C. Weil*, Effects of Real Property Abandonments in Bankruptcy,* 70 J. TAX'N 358, 358 (1989) (stating that section 108 exclusions operate as deferral only if a tax attribute "that has been reduced could have been used").

bankruptcy case.[117] Eight, basis is reduced only to the extent of the excess of the aggregate of the bases of the property held by the taxpayer immediately after discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.[118] Thus, if the remaining liabilities immediately after the discharge exceed the aggregate basis in property held by the taxpayer immediately after the discharge, then no basis reduction is necessary. However, if the aggregate basis in property held by the taxpayer exceeds the remaining liabilities immediately after the discharge, then basis reduction is necessary to the extent of remaining liabilities.[119]

An insolvent or title 11 taxpayer may elect under IRC §108(b)(5) to reduce the basis of its depreciable property by the amount of COD income before reducing tax attributes under section 108(b).[120] Depreciable property includes any property subject to a depreciation allowance, but only if a basis reduction will also reduce the amount of depreciation or amortization allowable in the period subsequent to the reduction.[121] Furthermore, a taxpayer may elect to include as depreciable property, real property held as inventory.[122] If the election is made, attributes are reduced in the following order:

1. Tax basis in depreciable property to zero basis;

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[117] *See generally* Treas. Reg. §1.1017-1.

[118] IRC §1017(b)(2).

[119] However, if a taxpayer elects to reduce basis in depreciable property under IRC §108(b)(5), then the limitation in IRC §1017(b)(2) does not apply.

[120] IRC § 108(d)(5).

[121] *Id.* § 1017(b)(3)(B).

[122] *Id.* § 1017(b)(3)(E). The election may either be made on the debtor's return for the taxable year of the discharge or in accordance with any regulations which may be issued, and may be revoked only with the consent of the Secretary of the Treasury. *Id.* § 1017(b)(3)(E)(ii). If the taxpayer establishes a reasonable cause for failure to file the election with the original return, the election may be filed with an amended return or claim for credit or refund. Temp. Treas. Reg. § 301.9100-14T (as amended in 1992). In addition, when a debtor corporation owns stock in another corporation and both corporations are members of an affiliated group filing a consolidated return for the year of the discharge, the subsidiary's stock is considered depreciable property if the subsidiary consents to a corresponding adjustment to its basis in depreciable property. IRC § 1017(b)(3)(D). Similarly, a partner's interest in a partnership can be depreciable property for this purpose to the extent of that partner's proportionate interest in depreciable property held by the partnership, but only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to that partner. *Id.* § 1017(b)(3)(C).

2. Carryovers and credits (NOLs, capital loss and credits) except foreign tax credits;
3. Tax basis in nondepreciable property up to the point of remaining liabilities; and
4. Foreign tax credit carryovers.

VII. MORTGAGE FORECLOSURES

Foreclosure has been a hot topic and an often discussed matter over the last several years. Many attorneys, some of whom had never done a foreclosure previously, have become quite experienced and proficient with foreclosure actions and confirmation hearings, where applicable. Discussed less often, and perhaps less understood, are the potential tax ramifications that may flow from a foreclosure or a "short sale." This section of the outline will provide a primer on the tax consequences, and a look at a few examples of the more likely scenarios that one may encounter outside of a bankruptcy case.

A few overarching legal principles must be understood before embarking on the examples set forth below. Two of these principles - that cancellation of debt generates income, and that of the exclusion of gain from the sale of a primary residence under IRC section 121 - have been around for some time and are likely to remain. The third legal principle, the exclusion of COD income under certain circumstances, has been available only since 2007, and was extended through January 1, 2021 (and will likely be extended again).

A. COD GENERATES TAXABLE INCOME

As a general rule, COD for which a taxpayer is personally liable will result in taxable income to that taxpayer. Since virtually all home purchases using loans involve recourse indebtedness, the COD provisions generally will apply to home foreclosures and short sales.

The policy for the present treatment of COD can easily be justified. The borrower with COD achieves in essence what is often referred to as "wealth accession." He may have received a sum equal to the amount cancelled or forgiven by having his debt "paid" for him or on his behalf by another.

In theory, this COD policy for the most part seeks to place comparable taxpayers on an equal footing but, in fact, does not go quite far enough to achieve the goal of horizontal equity. Compare two taxpayers – one of whom saves $100,000. In order to save this amount of money that taxpayer likely would have had to earn and pay taxes on $120,000 to $135,000 of income. This taxpayer utilizes the $100,000 as a 50% down payment on a home.

The second taxpayer does not have any savings, but desires to purchase a comparable priced home, borrowing the full $200,000. Since the second taxpayer is liable for the repayment of this debt, it is not viewed as income, but solely as an increase in his debt load.

A year after each has purchased his home, financial catastrophe strikes, and each of the homes is foreclosed at a bid price of $100,000. The net effect to the lender for each is $100,000 at the foreclosure sale, leaving a deficiency of $100,000. At this point, neither owner has anything. Owner 1 has lost his home along with his initial $100,000 in equity. Owner 2 has lost his home, but had no initial equity in the home and the deficiency of $100,000 is forgiven or canceled. The net economic effect is Owner 2 has lost nothing. The forgiveness has put Owner 2 on equal footing with Owner 1 – each receiving the "benefit" of losing $100,000 - but only Owner 1 was required to pay taxes on that $100,000.

Under these circumstances, Owner 2 would generally be required to recognize $100,000 in income and pay tax on that amount. Though this may come as a heavy burden, Owner 2 is still actually receiving more favorable treatment. Owner 2 merely recognizes the amount of debt forgiven – the $100,000 – and pays his marginal tax rate on that amount. Owner 1's lost $100,000 was after-tax monies, meaning Owner 1 likely had to pay taxes on an amount significantly more than $100,000

B. GAIN FROM SALE OF PRINCIPAL RESIDENCE EXCLUDED FROM INCOME

Under IRC section 121 a taxpayer is permitted to exclude from income any gain up to $250,000 ($500,000 for certain married taxpayers) resulting from a sale of their primary residence. Section 121 is satisfied if a taxpayer owns and resides in the primary residence aggregating at least two of five years preceding the sale or exchange.

This exclusion from income would have no effect on the above scenario, since neither taxpayer had gain. In fact, each indeed had an actual loss. Owner 2 did have income ($100,000), but no gain. However, there are some settings where this exclusion may be able to be utilized by a taxpayer that has received COD income from a loan modification that reduces a portion of the outstanding debt principal. (*See* example below).

C. THE MORTGAGE FORGIVENESS DEBT RELIEF ACT EXAMPLES

The Mortgage Forgiveness Debt Relief Act of 2007 [extended through January 1, 2021] ("MFDRA") applies only to forgiven, canceled, or restructured mortgage debt during calendar years 2007 – 2020 [with bills pending in Congress to extend the MFDRA again] on a primary residence, and not a second or investment home.[123] This exclusion applies only to forgiven or cancelled indebtedness used to buy, build, or substantially improve the principal residence.[124] Moreover, the debt must be secured by the main home. Debt incurred through refinancing poses an additional complexity. If the refinancing relates to the principal balance of an old mortgage that itself would have qualified under this exclusion, then the refinancing qualifies.[125]

[123] IRC §108(h); IRS Publication 4681; IRS Form 982.
[124] IRC §108(h)(2).
[125] IRS Publication 4681.

The exclusion can be quite substantial, since the law allows up to the maximum exemption amount of $2 million ($1 million if married filing separately).[126] At an assumed top marginal tax rate of about 40%, this could result in a tax savings of $800,000.

Usually, a lender (the typical counter-party to these transactions) reports the COD to the IRS and the taxpayer on a Form 1099-C, specifically box 2. If the amount in box 2 of Form 1099-C is incorrect, a taxpayer should quickly contact the lender that issued the Form 1099-C and have it corrected and a corrected Form 1099-C issued to the IRS and the taxpayer.

If a taxpayer employs the qualified principal residence indebtedness exclusion under section 108(a)(1)(e) and (h), he must report the excluded amount on IRS Form 982.[127] This Form must be attached to his return. There is no requirement that the taxpayer fill out the complete Form 982; rather, a taxpayer usually need only fill out lines 1e, 2, and 10b (this last entry if the taxpayer retained ownership in the main home).[128]

If a taxpayer excludes forgiven qualified principal indebtedness from income and continues to own the main home, he must reduce the basis in the main home by the amount of the canceled qualified principal residence indebtedness actually excluded from income.[129] In no case should the basis in the main home be reduced below zero. A taxpayer enters the amount of any basis reduction on line 10b, Form 982.

These are the basic principles to keep in mind while working through the common scenarios set forth below.

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[126] IRC §108(h)(2).
[127] IRS Publication 4681.
[128] IRS Publication 4681.
[129] IRS Publication 4681.

1. Scenario 1 (Typical Foreclosure)

Foreclosure on home that has declined below the value of the balance of the purchase money mortgage AND acquisition cost:

Purchase price of Home:	$400,000
Initial Loan Balance:	$380,000 (LTV ratio of 95%)
Value at time of Foreclosure:	$290,000
High Bid at Foreclosure:	$200,000
Deficiency:	$180,000

Lender elects not to, or denied the ability to pursue deficiency:

Recourse Debt (Property in Satisfaction of Debt):
Gain (Loss) = FMV – Basis
COD = Debt - FMV

Nonrecourse Debt (Property in Satisfaction of Debt):
Gain (Loss) = Debt – Basis
COD = $0

Amount of Debt Forgiven/COD:	$180,000 (this constitutes $180,000 of income)
MFDRA exclusion:	$180,000
Basis reduction:	$0 (taxpayer no longer owns home)

Result: No additional tax due if forgiveness (not the foreclosure) occurs before expiration of the MFDRA. IF the MFDRA does not apply, either because this was an investment property, second home, or MFDRA had expired, this debt forgiveness could result in a tax liability of up to $63,000. Note that in this Scenario, the FMV at the time of the foreclosure was $290,000, but the high bid was only $200,000. The COD is determined based on the FMV of the property, which is presumed to be the accepted bid price at the foreclosure sale absent fraud or collusion.

2. Scenario 2 (Cash Out)

Foreclosure of home that has increased in value of the acquisition cost but below the outstanding loan balance of the debt secured by the home. This scenario typically results from a

cash-out type refinancing. Here we must deal with the potential for a possibility of both gain and debt forgiveness.

Under the MFDRA, only that portion of the forgiven debt pertaining to the purchase (or construction or improvement) of the primary residence qualifies for exclusion. Consequently, any debt attributable to the "cash out" will constitute income that does not qualify for the exclusion.

Purchase price of Home:	$400,000
Initial Loan Balance:	$380,000 (LTV ratio of 95%)

Subsequently, the home increases in value to $600,000, and the owner borrows an additional $200,000:

Balance after refinancing:	$600,000
Value at Time of Foreclosure /High Bid at Foreclosure:	$475,000
Deficiency:	$125,000
Gain:	$75,000

Lender elects not to, or denied the ability to, pursue deficiency:

COD:	$125,000 (constitutes $125,000 of income)
MFDRA exclusion:	$0 (the amount forgiven is less than the non-purchase portion of the loan balance, $200,000)
Basis reduction:	$0 (taxpayer no longer owns home)

In this scenario, the $75,000 is excluded as IRC section 121 gain, so no tax is due on that portion. The COD income of $125,000, however, does not qualify for exclusion under the MFDRA because of the "ordering rule." "If only a part of the loan is qualified principal residence indebtedness,[130] the exclusion applies only to the extent the amount canceled is more than the amount of the loan (immediately before the cancellation) that is not qualified principal residence

[130] Qualified principal residence indebtedness includes only the debt used to buy, build, or improve a taxpayer's main home. IRC §163(h)(3)(B).

indebtedness." Additionally, the COD does not qualify for the IRC section 121 exclusion, which is a capital gain exclusion. Income from debt forgiveness is ordinary income, not capital gain.

Result: Absent insolvency or in bankruptcy issues, a tax liability on $125,000 of income accrues.

3. Scenario 3 (Home Retained)

Modification of Indebtedness involving Forgiveness of Debt; Ownership of Home Retained: A portion of the outstanding principal is forgiven in the loan renegotiation, and the home price partially or completely recovers later.

Purchase Price of Home:	$400,000
Initial Loan Balance:	$380,000 (LTV ratio of 95%)
Value time of Foreclosure:	$250,000

Now assume a modification of the indebtedness reducing the principal balance to $250,000 and forgiving the remaining $130,000. Subsequent to the modification, five years pass, value of home rises to $430,000. Home sold for $430,000. When the forgiveness of the $130,000 occurred it constituted forgiveness of debt, but it was excluded under the MFDRA. However, the forgiveness required that the basis in the property be reduced by the amount excluded under IRC section 108(a)(1)(e). Thus, this appears to be more a rule of tax deferment and not outright exclusion.

Basis before modification:	$400,000
Less loan forgiveness:	($130,000)
Basis after §108 application:	$270,000
Sales proceeds:	$430,000
Less adjusted basis:	($270,000)
Gain:	$160,000

Under this scenario, there is a larger degree of gain because of the COD. However, IRC section 121 would permit the exclusion of the entire gain. Nevertheless, taxpayer may not entirely

avoid paying any tax. In the event the gain at the time of the sale exceeds the amount of gain excluded by IRC section 121, a more likely occurrence with the reduction of the basis, the taxpayer may be liable for the gain. However, even if that be the case, the timing of any tax liability for the gain related to the COD exclusion has been significantly deferred.

D. MOVEMENT TO BANKRUPTCY

As discussed, a material modification of a home mortgage, a short sell, or a foreclosure may give rise to either COD income, section 1001 gain, or both. Well-established principles guide the resolution of these issues outside of bankruptcy. In bankruptcy, matters become more complex: who owes a tax; whether COD must be realized and recognized and by whom; whether gain is present; and, if a tax does exist, whether that tax is nondischargeable in a bankruptcy case are all questions that are top of mind. Parts VIII and IX address these issues.

VIII. IRC SECTION 1398: THE SEPARATE ENTITY RULES

One of the most important provisions of the BTA is IRC section 1398. Essentially, section 1398 creates a separate entity for purposes of federal income taxes in cases where an individual debtor files for relief under chapter 7 or chapter 11 of the BC. Following is a list of common questions and answers regarding the scope, purpose, and effect of section 1398.

A. WHEN DOES IRC SECTION 1398 APPLY?

Section 1398 applies only when an individual debtor files for relief under chapter 7 or chapter 11 of the BC. Thus, only the bankruptcy estate of an individual debtor in cases under chapter 7 or 11 is treated as a separate taxable entity. A separate taxable entity is not created in chapters 12 or 13 or in any case where the debtor is not an individual.[131]

B. WHAT IS THE PURPOSE OF IRC SECTION 1398?

Section 1398 furthers the fresh start policy embodied in the BC. The Committee Reports recognize that the purpose of bankruptcy is to provide for a debtor's ability to begin his or her economic life anew.[132] Congress recognized that any expenses incurred by the estate should not burden a debtor's fresh start. Consistent with this purpose is the fact that the income and losses of a separate taxable entity are computed separately from the individual debtor. Moreover, any estate tax liability is generally confined to the estate and its assets. Furthermore, by making the short-

[131] IRC §§ 1398(a), (b), and 1399.

[132] S. Rep. No. 1035, 96th Cong., 2d Sess. 24-25 (1980); *see generally* Jack F. Williams, *A Comment on the Tax Provisions of the National Bankruptcy Review Commission Report: The Good, The Bad, and The Ugly*, 5 Am. Bankr. Inst. L. Rev. 445-462 (1997)(symposium); Jack F. Williams, *National Bankruptcy Review Commission Recommendations on Tax Policy: Individual Debtors, Discharge, and Priority of Claims*, 14 Bankr. Dev. J. 101-171 (1997); Jack F. Williams, *The Federal Tax Consequences of Individual Debtor Chapter 11 Cases*, 46 S.C. L. Rev. 1203-1244 (1995)(symposium), *reprinted in* 47 Digest of Tax Articles 23-43 (1996); Jack F. Williams, *Rethinking Bankruptcy and Tax Policy*, 3 Am. Bankr. Inst. L. Rev. 153-206 (1995)(symposium); *see also* Robert W. Van Amburgh, *Tax Considerations For An Individual Debtor Contemplating Bankruptcy*, Annals Bankr. L. 93, 121-28.

year election, a debtor may be able to shift at least part of his or her tax liability to the estate as a BC section 507(a)(8) priority claim.[133]

C. HOW IS THE BANKRUPTCY ESTATE TAXED UNDER IRC SECTION 1398?

Consistent with its separate entity status, an estate computes its own taxable income in the same manner as an individual.[134] The estate is taxed at the same rate as a married individual filing separately.[135] The chapter 7 or 11 trustee is required to file any returns required by law and to pay any taxes due. The trustee must file a return for each taxable year that the estate's gross income exceeds the standard deduction and the exemption amount.[136]

D. MUST A TRUSTEE FILE A FEDERAL TAX RETURN WHERE THE ESTATE HAS GENERATED NO INCOME?

Possibly. The estate may be liable for taxes generated by cancellation of indebtedness income or by sale and exchange (i.e., a foreclosure on property that is property of the estate).

E. HOW IS THE GROSS INCOME OF A BANKRUPTCY ESTATE DETERMINED?

The bankruptcy estate's gross income includes the gross income of the debtor to which the estate is entitled under §§ 541(a)(1) through (a)(7). Property of the estate includes all of the debtor's legal or equitable interest in property wherever located. Section 1398 does not permit 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.[137]

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[133] *See* IRC § 1398(d); *see also* 1A Collier on Bankruptcy & 9.05 (15th ed. L. King ed.).
[134] IRC § 1398(c)(1).
[135] IRC §§ 1398(c)(2) and (c)(3).
[136] *See* Van Amburgh.
[137] *See generally* 1A Collier on Bankruptcy at & 9.04[3].

F. HOW IS INCOME TREATED WHERE EARNED PREPETITION, BUT RECEIVED POSTPETITION?

Section 1398(e)(1) provides that gross income of the estate does not include any amount received or accrued by the debtor before the commencement of the case. Thus, section 1398 was intended to override the assignment-of-income principles under tax law. An example may clarify the effect. Assume that a cash-basis individual who draws a weekly salary nonexempt under applicable state law earns one payment prior to the commencement of his or her chapter 7 case, but it is received by the estate after commencement. In that case, the estate and not the debtor would report the income.[138]

G. HOW IS COD INCOME TREATED UNDER THE SEPARATE ENTITY RULES?

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 section 61(a) unless it can be excluded under section 108(a). (There is a means by which to shift at least some of the tax consequences from the debtor to the estate through a section 1398 short-year election by the debtor). If the taxable event occurs after commencement of the case, then the estate should recognize the income under section 61(a) unless it can be excluded under section 108(a).

H. HOW ARE DEDUCTIONS TREATED UNDER THE SEPARATE ENTITY RULES?

Section 1398(e)(3) provides that the determination whether any amount paid or incurred by the estate is allowable as a deduction shall be made as if paid by the debtor and the debtor was

[138] *See* Van Amburgh at 123 (provides examples of cash-basis and accrual-basis debtors).

still engaged in the trade or business that the debtor was engaged in before the commencement of the case. It would appear that the same accounting method used for income should be used for deductions. Additionally, section 1398(e)(3) permits the estate to characterize some of its expenditures as trade or business expenses which can be used to offset current income of the estate. Furthermore, administrative expenses and any fees under chapter 123, Title 28, United States Code, are deductible by the estate to the extent not disallowed under another IRC section.[139] If the administrative expenses cannot be used in the current year then they may be carried back three years and carried forward seven years.[140]

I. ARE TRANSFERS OF ASSETS BETWEEN THE DEBTOR AND THE ESTATE TAXABLE EVENTS?

No. Transfers of assets from the debtor to the estate upon commencement of the case and from the estate to the debtor upon termination of the estate are not taxable events.[141]

J. DOES THE ESTATE SUCCEED TO THE DEBTOR'S TAX ATTRIBUTES?

Yes. The estate succeeds to certain enumerated tax attributes of the debtor upon commencement of the case.[142] 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

[139] IRC § 1398(h)(2).
[140] IRC § 398(h)(2)(C).
[141] IRC § 1398(f).
[142] *See* IRC § 1398(g).

the debtor, to the extent provided in regulations carrying out the purposes of section 1398.[143] The Service has issued regulations adding passive activity losses and credits to the list[144] and the section 121 exclusion of gain from the sale of a personal residence transferred to the estate.[145] Upon termination of the estate, any unused attributes are transferred back to the debtor.[146]

K. WHAT IS A "SHORT-YEAR" ELECTION? HOW IS THE ELECTION MADE?

Section 1398(d)(2) creates an election that a debtor may make to split his or her taxable year into *two* taxable years. This election is an important pre-bankruptcy planning tool that cannot be overlooked. The first taxable year-ends on the day before the day the bankruptcy case was commenced.[147] The second taxable year begins on the commencement date. Assume an individual debtor files for relief under chapter 7 on March 8 and shortly thereafter makes the IRC § 1398(d) election. As a consequence of the election, the debtor has two tax years. The first year spans from January 1 through March 7; the second year spans from March 8 through December 31. If the election is 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.[148] The short-year election is considered made if the complete tax return for the short period is timely filed.[149] In our working example, the return for the short period

[143] *See* McQueen and Williams, *supra* (helpful explanation of the listed attributes).
[144] *See* Treas. Regs. §§ 1.1398-1 and 1.1398-2.
[145] *See* Treas. Reg. §1.1398-3.
[146] IRC § 1398(I).
[147] A bankruptcy case is commenced upon the filing of the petition under BC §§ 301, 302, and 303.
[148] *See* IRC § 1398(d)(1). The debtor cannot make the short-year election if he or she has no assets other than exempt property. IRC § 1398(d)(2)(C).
[149] *See* Temp. Treas. Reg. § 7a.2(d) (1981); Treas. Reg. § 1.6081-1(b)(2).

ending March 7 should be filed by July 15. The debtor should conspicuously write "**SECTION 1398 ELECTION**" at the top of the return.[150]

L. WHEN MUST THE SHORT-YEAR ELECTION BE MADE BY A DEBTOR?

The short-year election must be made by the debtor on or before the date for filing his or her return for the short-taxable year.[151] 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. 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.[152] Again, the election must be made on the return. Once made, the election is irrevocable.[153]

M. WHAT IS THE EFFECT OF MAKING THE SHORT-YEAR ELECTION?

The short-year election may be the most potent pre-bankruptcy planning tool 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)(8) priority claim against the estate. Thus, the debtor may essentially force his or her unsecured creditors to pay all or a portion of the first short-year tax claim. Of course, if there are insufficient assets to pay the short-year tax claims in full, they do survive the bankruptcy as a non-dischargeable claim under BC section 523(a)(1). If the debtor fails to make the election, then any tax liability for the complete year is not an allowable claim against the estate.[154] Moreover, if a debtor makes the election, then

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[150]Temp. Treas. Reg. § 7a.2(d) (1981). For an excellent discussion on requesting extensions to file the short-year return, see 1A Collier on Bankruptcy at & 9.05[b]. *See generally* James I. Shepard, The Trustee's Bankruptcy Tax Manual 157-58 (recent edition).

[151]IRC § 1398(d)(2)(D).

[152]Temp. Treas. Reg. § 7a. 2(d).

[153]IRC § 1398(d)(2)(D).

[154]*See* S. Rep. No. 1035, 96th Cong., 2d Sess. 26 (1980).

a 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, a debtor's tax attributes as of the end of the full taxable year carryover.

N. WHEN IS IT ADVISABLE FOR A DEBTOR TO MAKE THE SHORT-YEAR ELECTION?

There is no easy answer to the question posed. Whether a debtor should make the IRC § 1398 election depends on the particular facts and circumstances at hand. As a general rule it appears that in most cases the election should be made.[155] By making the election, a debtor is able to shift at least some of the tax liability to the estate as an allowable BC section 507(a)(8) priority claim. However, if the claim is not satisfied it will be nondischargeable and survive the bankruptcy. There may be circumstances present to dissuade a debtor from making the election when substantial net operating losses are involved. For example, 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.[156]

Nondischargeable taxes are the antithesis of an individual's fresh start. Yet, the drafters of the BC struck the synthesis in favor of the taxing authorities at least as to those tax claims identified in section 523(a)(1). Nevertheless, all is not lost for an individual debtor and his or her bankruptcy counsel in reducing possible tax consequences in contemplation of a bankruptcy filing. Although experience has shown that an individual debtor should most often make the short-year election,

[155]Van Amburgh at 144; *see also* Shepard at 150-57.
[156]Van Amburgh at 145; *see also* 1A Collier on Bankruptcy at & 9.05[3]; Shepard at 150-157.

there are many instances where the election should not be made. Counsel must be aware of when a debtor should make the election and when a debtor should not. Often times, there are no easy rules, no easy answers. Nevertheless, section 1398 with all its nuances and ramifications cannot be ignored before and during bankruptcy.

Example 10: THE MALPRACTICE TRAP

Example 10-1: A partnership applies for relief under chapter 7. May the partnership make a § 1398 election? *No. Only individual debtors may benefit from IRC § 1398. See IRC § 1399.*

Example 10-2: Elrod, a partner in the partnership identified above, seeks relief under chapter 13. May Elrod benefit from the § 1398 election. *No. An individual debtor must file for relief under chapter 7 or 11 only to benefit from § 1398.*

Example 10-3: Assume Debtor is a cash basis taxpayer with a calendar year tax year (January 1 – December 31). Debtor filed for chapter 7 bankruptcy relief on August 1, 20XX. In the seven months before the commencement of a bankruptcy case, Debtor had income giving rise to a tax of $25,000. *If Debtor fails to make the election, there is no interruption in her tax year. The tax would be due at the end of her tax year (31 December) and payable by the fifteenth day of the fourth month following the close of her tax year (15 April). The tax claim would not participate in the chapter 7 distribution in that it is a postpetition claim. However, it would not be discharged in the chapter 7 case. If the Debtor makes the election, she will have two tax years. The first short year runs from 1 January to 31 July. The second runs from August 1 to December 31. Now, the postpetition claim magically becomes a prepetition one due as of the end of the new short tax year. This is also a § 507(a)(8) priority claim that is nonetheless not subject to discharge as delineated in § 523(a).* ***Practice pointer: Make the election.***

Example 10-4: Same facts as above. However, in the previous tax years, Debtor had generated net operating losses (NOLs) that can be carried forward or back to other tax years. An NOL is a surplus deduction that tax law allows you to apply to other tax years. *If Debtor does not make the election, then these tax attributes will pass to the bankruptcy estate and can be used by the trustee to reduce the estate's tax liability. Any unused losses would then pass back to Debtor upon termination of the case. If Debtor makes the election, then she is entitled to use them herself.* ***Practice pointer: Make the election.***

Example 10-5: Same facts as above except that the NOLs arose in the seven months preceding the commencement of the case. Further assume that she had no income in the first seven months of the tax year and expects substantial income in the last five months of the year. *Without the election, Debtor will be able to use the deductions against postpetition income. With the election, the bankruptcy trustee gets to use the losses and Debtor's income cannot be offset by the deductions.* ***Practice pointer: Do not make the election.***

IX. DISCHARGE OF TAXES

A. SCOPE OF DISCHARGE

An individual's most important bankruptcy objective is a discharge from his or her debts.[157] The discharge is at the heart of the fresh start policy promoted by the BC and the BTA. The chapter 7 discharge is granted virtually automatically unless an objecting party can establish that the debtor has engaged in prohibited conduct, usually constituting some type of fraud or bankruptcy crime.[158] The statute providing for discharge is liberally construed in favor of an individual debtor.[159] Thus, the objecting party has the burden of establishing a ground for the denial of a discharge.[160]

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[157] *See generally* Douglas G. Baird, The Elements of Bankruptcy 27-44 (1992) (discuss fresh start policy); David G. Epstein, Steve H. Nickles, & James J. White, 2 Bankruptcy § 7-16 (1993)(same).

[158] *See* 11 U.S.C. §§ 727(a)(1) through (a)(10).

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

[160] 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. Although understood as part of the warp and wolf of bankruptcy law, the right to discharge was not a part of the early enactments of bankruptcy acts in the United States. The Supreme Court noted the comparative newness of the discharge and fresh-start policy in bankruptcy in *United States v. Kras*, 409 U.S. 414, 446-47 (1973). 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 who has not abused the bankruptcy process. *See In re Wheeler*, 101 BR 39 (Bankr. N.D. Ohio 1988). A discharge in a bankruptcy case voids any judgment to the extent that it is a determination of the personal liability of the debtor with respect to a prepetition debt. *See* 11 U.S.C. § 524(a). 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 contacts, to collect, recover, or offset any discharged debt. Id. In effect, the discharge is a total prohibition on debt collection efforts against a debtor. However, a discharge of the debtor does not discharge those liable on the debt along with the debtor, including guarantors, co-makers, or partners. 11 U.S.C.§ 524(e). Furthermore, under BC § 524, any attempt to reaffirm a discharged debt is void unless the provisions of the Bankruptcy Code delineating the requirements of reaffirmation are specifically followed. *See* 11 U.S.C. § 524(c). To ensure the effectiveness of the discharge, § 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 Bankruptcy Code, was insolvent before the bankruptcy case, or has not paid a dischargeable debt. 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 Code, or an individual associated with a debtor under the Code, solely because the debtor is or has been a debtor under the Code, was insolvent before the commencement of case under the Code, or has not paid a debt that is dischargeable under the Code. *See generally* D. Epstein, S. Nickles, & J. White at 7-40.

Under chapter 11, section 1141(d) governs the scope and limits of 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. Unlike section 727(a), a partnership, corporation, or an individual may receive a section 1141(d) discharge.[161] The section 1141(d) discharge is broader than the section 727(a) discharge in that the latter discharges any debts that *arose*[162] before the *order for relief*,[163] while the former discharges any debts that arose before the *confirmation of the plan*.[164]

B. EXCEPTIONS OF DEBT FROM DISCHARGE

Notwithstanding the debtor's discharge under the Code, certain debts are excepted from discharge as a matter of public policy pursuant to section 523(a). These exceptions to discharge are strictly construed. 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 section 523(a). If successful in asserting section 523(a), the creditor's claim will not be discharged and will survive the bankruptcy case; that is, a section 523(a) claim may be enforced and ultimately satisfied even after the bankruptcy case. Thus, although the debtor receives a general discharge, the section 523(a) claims live on.

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[161] In *Toibb v. Radloff*, 111 S. Ct. 2197 (1991), the Supreme Court held that an individual may properly seek relief under chapter 11 of the Bankruptcy Code.

[162] It should come as no surprise that just when a debt *arises* has become a bone of contention. D. Epstein, S. Nickles, & J. White 7-16, at 312.

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

[164] For the requirements for chapter 11 plan confirmation, see 11 U.S.C. § 1129.

Section 523 of the BC generally specifies which debts of an *individual debtor* are not discharged in a bankruptcy case under section 727 of chapter 7, section 1141 of chapter 11, or section 1328(a) and (b) of chapter 13 (the "super-discharge" and the "hardship" discharge). Included among these debts are certain taxes which are identified as nondischargeable.[165]

C. PRIORITY TAX CLAIMS

The first category of nondischargeable tax claims is set forth in section 523(a)(1)(A).[166] This category also happens to include the priority tax claims identified in section 507(a)(8). Thus, unlike the remaining two categories of nondischargeable tax claims, this particular category may participate in the distribution of estate assets under section 726 as a priority tax claim, in effect forcing the unsecured creditors of the estate to subsidize the tax obligation of the debtor. Therefore, it is incumbent on the debtor to ensure that such tax claim be filed by the taxing authority or to take the steps himself to file a claim on behalf of the taxing authority.

Under this section, a tax or customs duty specified in § 507(a)(3) as an involuntary gap claim[167] or § 507(a)(8)[168] is nondischargeable whether or not a claim for such tax was allowed by

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[165] In *In re Olsen*, 123 B.R. 312 (Bankr. N.D. Ill. 1991), the bankruptcy court held that a nondischargeable tax claim survives bankruptcy regardless of whether such claim was filed or allowed in the bankruptcy case.

[166] 11 USC § 523(a)(1), which reads as follows:

A discharge under section 727, 1141, or 1328(b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507(a)(3) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, if required--

(i) was not filed; or

(ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.

[167] 11 U.S.C § 523(a)(1)(A); 11 USC § 507(a)(3)(this section relates to the priority of involuntary gap claims).

[168] 11 U.S.C. § 523(a)(1)(A); 11 USC § 507(a)(8)(this section relates to the priority of allowed unsecured tax claims of *governmental units*)

the court or filed in the case.[169] These priority and nondischargeable tax claims include the following:

1. Involuntary gap claims under § 507(a)(3).[170]
2. Income or gross receipts taxes incurred (that is, measured by the last date by which a return could be filed without penalty) prepetition and within three years from the filing of the bankruptcy petition.[171] An easier approach in applying this rule is to go back three years from the petition date and look forward. Any subsequent return due date (including extensions) that can be "seen" as one looks "into the future" will mean that the taxes associated with that tax year are nondischargeable. Moreover, it is the first petition date and not any conversion date that constitutes the measuring date. Under § 507(a)(8), the three-year period is suspended if the automatic stay is in effect. Thus, a debtor cannot hide in a chapter 13 case for the purpose of "running out" the three year clock. Once the stay is no longer in effect, the clock begins to run again at the place at which it last stopped plus an additional ninety days. A practitioner should order the tax history (MFTRA-X) of her client to ascertain when returns were due, including extensions filed. One can request that information through calling the Tax Practitioner Hotline at 866-860-4259 or by ordering on-line through the E-Services for Tax Professionals Portal.

   Example 11:

   Taxpayer files a bankruptcy petition under chapter 7 May 1, 2012. Assume Taxpayer is a calendar year cash basis taxpayer. Thus, a tax return associated with taxes for Tax Year 20XX must be filed as of 15 April of 20XX + 1 (or 15 October 20XX + 1 if an extension is timely filed). What taxes would constitute priority claims under section 507(a)(8)(A)(i)?

   Answer:

[169] 11 USC § 523(a)(1)(A).

[170] The third priority as set forth in § 507(a)(3) of the Bankruptcy Code is "unsecured claims allowed under § 502(f) of this title." Under § 502(f), an *involuntary gap* claim is one which arises in the ordinary course of a debtor's business after the filing of an involuntary petition against the debtor but before either the appointment of a trustee or the entry of an order for relief. An involuntary gap claim is allowed "the same as if such claim had arisen before the date of the filing of the petition." The involuntary gap claim is the creature of the involuntary bankruptcy case. Recall that the filing of an involuntary petition against the debtor does not operate as an order for relief under the Bankruptcy Code. This priority speaks directly to the time delay made possible by segregating the order for relief from the filing of the petition.

[171] An eighth priority is allowed by § 507(a)(8)(A)(i) of the Bankruptcy Code for unsecured federal tax liens ("unsecured claims of governmental units") to the extent that such claims are for income or gross receipts taxes incurred before the filing of the bankruptcy petition for which the due date of the tax return (including any extension) occurred within three years before the date the bankruptcy petition was filed or for which the due date of the return (including any extensions) occurred after the filing of the petition. As indicated, the due date of the return, and not the date when the taxes are assessed, determines the priority.

Year	Priority	Prepetition Claim
2012	No	No
2011	Yes	Yes
2010	Yes	Yes
2009	Yes	Yes
2008	No (unless extension)	Yes (status?)

3. Income or gross receipts taxes assessed within 240 days from the filing of the bankruptcy petition.[172] This will require the practitioner to obtain evidence of the assessment date, if any. For federal taxes, one can obtain a proof of assessment by requesting a Form 23-C Assessment Certificate, the MFTRA-X tax history, the From 4340 Certificate of Assessments and Payments, or by looking for transaction codes 150, 290, or 300 (and a few others) from the Account Transcript.

4. Income or gross receipts taxes still assessable under applicable law at the time the bankruptcy petition is filed.[173] These taxes generally include those years that are still under audit risk, tax issues pending in the Tax Court, and taxes associated with a Form 872-A Consent to Extend Time for Assessment (open ended).

5. Recent property taxes assessed prepetition and last due without penalty within one year of the filing.[174]

6. Trust fund taxes incurred at any time, including the *employee's share* of payroll taxes that an employer is required to withhold and, in many states, sales tax.[175]

7. The *employer's share* of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition to the extent the return for such taxes was last due (including any extensions of time) within

[172]Also included are income and gross receipts taxes assessed at any time within 240 days before the date the bankruptcy petition was filed. The 240-day period is extended for the period of time an offer of compromise is considered by the IRS after submission by the taxpayer, plus 30 days after such offer is rejected. Under this rule, the date on which the IRS assesses the tax, rather than the date of the return, determines the priority.

[173]Section 507(a)(8)(A)(iii) grants priority to income and gross receipts taxes not assessed before the filing of a bankruptcy petition, but which are still permitted to be assessed under applicable tax laws. Accordingly, a prepetition and unsecured federal tax lien will still receive an eighth priority under this section if the statute of limitations still allows an assessment of the tax liability after the bankruptcy petition is filed, even though such assessment was not made within the 240-day period (plus any extension) prior to the bankruptcy filing.

[174]An unsecured claim of a governmental unit for property taxes assessed before the bankruptcy petition was filed and last payable without penalty within one year before the filing of the petition is given an eighth priority.

[175]Taxes required to be collected or withheld and for which the debtor is liable in whatever capacity are given an eighth priority under § 507(a)(8)(C) of the Bankruptcy Code.

three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed.[176]

8. Excise taxes related to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition.[177]

9. Certain customs duty under § 507(a)(8)(F) of the BC.[178]

D. MISCONDUCT TAX CLAIMS

The second category of nondischargeable tax claims is set forth in BC sections 523(a)(1)(B) and (C) and include the following taxes:

1. Tax liabilities relating to a tax return which was not filed.[179] There have been several cases that have struggled with what constitutes a "return" for these purposes. The Bankruptcy Abuse Prevention and Consumer

[176]The *employer's* share of employment taxes on wages earned from the debtor and paid *before* the filing of a bankruptcy petition receives an eighth priority under § 507(a)(8)(D) of the Bankruptcy Code, to the extent the return for such taxes was last due (including any extensions of time) within three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed. Older tax claims of this nature are payable as nonpriority general claims. The *employee's* share of employment taxes on wages earned from a debtor and paid before the filing of a bankruptcy petition also receives an eighth priority as a trust fund tax liability without a three-year limitation.

[177]Unsecured claims for excise taxes are given an eighth priority under § 507(a)(8)(E) of the Bankruptcy Code. The excise taxes claimed must relate to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition. If a return is due, the three year period is extended if the due date for filing the return was extended. 11 U.S.C. § 507(a)(8)(E). If a return is not required, the tax claim must relate to a transaction which itself occurred within three years prior to the filing of the bankruptcy petition. For purposes of this priority, excise taxes covered include sales taxes, estate and gift taxes, gasoline and special fuel taxes, wagering taxes, and truck taxes.

[178]Unsecured claims for customs duty are given an eighth priority under § 507(a)(8)(F) of the Bankruptcy Code. According to the legislative history, this priority covers duties on imports entered for consumption within one year before the filing of the petition, but which are still unliquidated on the petition date; duties covered by an entry liquidated or unliquidated within one year before the petition date; and any duty on merchandise entered for consumption within four years before the petition but not liquidated as of the petition date, if the Secretary of the Treasury or his or her delegate certifies that duties were not liquidated because of possible assessment of antidumping or countervailing duties or fraud penalties.

[179]*See*, *e.g.*, *In re Bergstrom*, 949 F.2nd 341 (10th Cir. 1991), where the United States Court of Appeals for the Tenth Circuit held that the term "filed return" was not broad enough to include a substitute return prepared by the IRS, absent the debtor's signature thereon; *In re Pruitt*, 107 B.R. 764 (Bankr. D. Wyo. 1989), where the bankruptcy court held that substitute tax returns filed by the Internal Revenue Service when the debtor failed to file such returns for several years did not preclude application of the Bankruptcy Code rendering tax debts nondischargeable for any tax debt with respect to which a return was required and not filed; *In re Brookman*, 114 B.R. 769 (Bankr. M.D. Fla. 1990), where the bankruptcy court held that the debt for unpaid income taxes was nondischargeable because the debtor failed to rebut prima facie evidence that the tax return for the applicable tax year was not filed; *In re Crawford*, 115 B.R. 381 (Bankr. N.D. Ga. 1990), where the bankruptcy court held that a tax obligation for which the debtor did not file a tax return is non-dischargeable even though the Internal Revenue Service filed the return on the debtor's behalf.

Protection Act of 2005 (BAPCPA)[180] has now defined a return by reference to applicable nonbankruptcy law. Thus, for federal income tax purposes, a return includes a §6020(a) return where a taxpayer signs it, a written stipulation to a judgment, and a final order by a court of competent jurisdiction. However, a SFR or Substitute for Return assessment (code 290 or 300) prepared by the IRS, any return where the *jurat* has been altered or the return is unsigned, or any return filed in the wrong place do not constitute a return for these purposes. May a taxpayer file a return after the Service has prepared an SFR assessment and meet the return requirement? Five circuits have concluded no but there is some emerging authority to the contrary. The Eleventh Circuit, however, rejected the "one-day" late rule embraced by the First, Fifth, and Tenth Circuits in *In re Justice*, No. 15-10273, 2016 WL 1237766 (11th Cir. Mar. 30, 2016). The Eleventh Circuit rejected the per se rule; rather, it focused its attention on whether the facts and circumstances support a finding that the debtor-taxpayer had undertaken an honest and reasonable attempt to comply with the tax laws. However, just because there is an SFR assessment (code 290 or 300) on the transcript does not end the inquiry; a return can be nondischargeable if it was actually filed before the SFR assessment.

2. Tax liabilities reported by a tax return filed late *and* filed within two years prior to the filing of the bankruptcy petition or filed after the bankruptcy petition;

[180] Pub.L. 109-9, 119 Stat. 23, enacted April 20, 2005.

3. Tax liabilities reported by a fraudulent return[181] or from an attempt by the debtor to willfully evade or avoid any tax.[182] Here, the courts have employed the civil and not criminal fraud standards. However, there are several approaches that do diverge in the hard cases. Generally, the government must prove some conduct on the part of the debtor and a requisite state of mind. To satisfy the conduct requirement, courts look to something more than the failure to pay the tax. For example, the recurrence of an understatement of income, inadequate records, asset transfers, false W-4's, no returns filed, barter transaction history, cash business history, and other forms of concealment may be sufficient to meet the conduct test. As for the state of mind requirement, the civil standard usually mirroring the IRC §6672 responsible person standards for the imposition of trust fund liability are sufficient. Thus, an intentional, knowing, and voluntary act is all that is necessary. In a joint return situation, the state of mind of one spouse will not be imputed to the other spouse.

E. TAX PENALTIES

The third category of nondischargeable taxes is set forth in § 523(a)(7).[183] This section provides that tax penalties which are basically punitive in nature are nondischargeable only if the

[181] 11 USC § 523(a)(1)(B); *see* 124 Cong. Rec. H11,113-14 (daily ed Sept 28, 1978); S 17,430-31 (daily ed Oct 6, 1978); *see also In re Graham*, 108 B.R. 498 (Bankr. E.D. Pa. 1989), where the bankruptcy court held that a prepetition tax court decision holding the debtor liable to the IRS for the debtor's underpayment of taxes, but which did not decide that the underpayment was fraudulent, did not preclude the debtor from disputing the government's claim that such tax liabilities were non-dischargeable for fraud; *In re Fernandez*, 112 B.R. 888 (Bankr. N.D. Ohio 1990), where the bankruptcy court held that the debtor's conduct concerning tax obligations was shown to be willful and evasive and thus, the tax obligations were deemed nondischargeable; *In re Kirk*, 114 B.R. 771 (Bankr. N.D. Fla. 1990), where the bankruptcy court held that the debtors' conduct demonstrated a purposeful attempt to evade income taxes and thus, the claim of the IRS for civil fraud penalties was allowed; *In re Carapella*, 115 B.R. 365 (N.D. Fla. 1990), where the district court held that the tax liability of a chapter 7 debtor for a fraudulent return filed by the debtor was nondischargeable; *In re Gilder*, 122 B.R. 593 (Bankr. M.D. Fla. 1990), where the bankruptcy court held that where the debtor submitted false withholding statements for the express purpose for eliminating the withholding of federal income taxes from wages, such conduct was a "willful attempt to evade or defeat tax" within the meaning of the exception to discharge; *In re Hopkins*, 133 B.R. 102 (Bankr. M.D. Ohio 1991), where the bankruptcy court held that the wife's signing of joint returns which she knew were in error constituted the making of a fraudulent return or willfully attempting to evade such tax and, thus, such tax debts were nondischargeable in the wife's bankruptcy case; *In re Peterson*, 132 B.R. 68 (Bankr. D. Wyo. 1991), where the bankruptcy court held that the debtor did not "willfully" attempt to evade tax by signing returns which the government admits were not fraudulent and then filing for relief under chapter 7 shortly after such taxes became eligible to be dischargeable; *In re Graham*, 973 F.2d 1089 (3d Cir. 1992), where the United States Court of Appeals for the Third Circuit held that a United States Tax Court judgment holding the debtors liable for income tax deficiencies resulting from fraudulent tax returns did not have claim preclusion or issue preclusion effect in determining whether the debtors' liability was nondischargeable; *In re Levinson*, 969 F.2d 260 (7th Cir. 1992), where the United States Court of Appeals for the Seventh Circuit held that the evidence was sufficient to support a determination that the debtor had filed fraudulent tax returns so as to render the tax debts nondischargeable.

[182] 11 U.S.C. § 523(a)(1).

[183] 11 USC § 523(a)(7), which reads as follows:

penalty is computed by reference to a related tax liability which is also nondischargeable. It appears that if the amount of the penalty is not computed by reference to a tax liability, the transaction or event giving rise to the penalty must occur during a three-year period ending on the date of the filing of the bankruptcy petition.[184]

F. TAX CLAIMS IN INDIVIDUAL DEBTOR CHAPTER 11 CASES

With respect to individual debtors in reorganization under chapter 11, section 1141(d)(2) of the BC incorporates by reference the exceptions to discharge set forth in section 523 and discussed above.[185] Section 1141(d)(2) of the BC provides that the confirmation of a chapter 11 plan does not discharge an *individual debtor* from any debt excepted from discharge under section 523.[186]

With respect to all debtors (*i.e.*, including corporations and partnerships), the confirmation of a chapter 11 plan does not discharge the debtor from any debts (including taxes) if:

1. The plan provides for the liquidation of all or substantially all of the property of the estate
2. The debtor does not engage in business after consummation of the plan
3. The debtor would be denied a discharge under § 727(a) of the BC if the case were a chapter 7 liquidation proceeding.[187]

(a) A discharge under Section 727, 1141, or 1328(b) of this title does not discharge an individual debtor from any debt--

(7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty-

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.

[184]124 Cong Rec H11,113-14 (daily ed Sept 28, 1978); S 17,430-31 (daily ed Oct 6, 1978); *see also* Rev Rul 68-574, 1968-2 CB 595.

[185]124 Cong. Rec. H11,113-14 (daily ed Sept 28, 1978); S. 17,430-31 (daily ed Oct 6, 1978).

[186]11 USC §§ 1141(d)(2) and 523.

[187]*Id.* § 1141(d)(3).

Thus, a debtor is not discharged from any debt (including federal taxes) by the confirmation of a plan if the plan is a liquidation plan and if the debtor would be denied a discharge in a chapter 7 liquidation proceeding pursuant to section 727(a) of the BC.[188] Under section 727(a)(1), only an individual, and not a corporation or a partnership, may obtain a discharge.[189]

G. TAX CLAIMS IN CHAPTER 13 CASES

Prior to 2005, the chapter 13 discharge was sufficiently broad in scope that most tax claims could be discharged, even those under section 523(a). However, BAPCPA changed that result, conforming the chapter 13 discharge with that under chapter 7. Thus, after a debtor has made all payments required by the chapter 13 plan, the bankruptcy court grants to the debtor a discharge of all debts provided for by the plan or disallowed under section 502, except the following debts:

1. Debts with the final payment falling due after the final payment under the plan is due as set forth in section 1322(b)(5), that is, certain long-term debt;[190]
2. Debts in the form of trust fund taxes; nonfiler taxes; fraudulent taxes or taxes arising from a willful intent to evade; debts incurred under false pretenses; unlisted debt; debts from fraud, etc., when in a fiduciary capacity; domestic support obligations; certain student loans that do not pose an undue hardship to the debtor; debts for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft while intoxicated;
3. Debts for restitution included in a sentence on the debtor's conviction of a crime;[191] and
4. Debts for restitution or damages awarded in a civil action against the debtor as a result of willful or malicious injury by the debtors that caused personal injury to an individual or the death of an individual.

[188] S Rep No 989, 95th Cong, 2d Sess 129 (1978).
[189] 11 U.S.C. § 727(a)(1).
[190] 11 U.S.C. § 1328(a)(1).
[191] 11 U.S.C. § 1328(a).

H. DISCHARGE PROCEDURES

An action to except a debt from discharge under section 523 is an adversary proceeding under Part VII of the Bankruptcy Rules. It is commenced by the service of a summons and complaint in accordance with Bankr. R. 4. The Federal Rules of Civil Procedure ("FRCivP") generally apply to adversary proceedings through Part VII of the Bankruptcy Rules, although several Bankruptcy Rules have non-FRCivP provisions.

The burden of proof to assert that the debt is non-dischargeable under section 523(a) falls squarely on the shoulders of the creditor asserting the exception and not necessarily the plaintiff for reasons soon to become apparent. Unlike many grounds for an exception to discharge that must be brought by the applicable bar date in a bankruptcy case, tax claims that may survive the discharge can be asserted against the individual debtor *in personam* well after the bar date has run or even past the closing of the bankruptcy case. Thus, it may be beneficial for the debtor to commence an adversary proceeding against the relevant taxing authority for a determination of whether the tax claim is dischargeable while the bankruptcy case is pending. If that be the case, the taxing authority still has the burden to prove that the tax claim is nondischargeable. Although there is some authority to allow re-opening of a bankruptcy case that has been closed under section 350, this is simply too thin a reed to rest such an important determination. Thus, a bankruptcy practitioner should carefully consider the tactical and strategic advantageous to the commencement of an adversary proceeding where the taxing authority has failed to do so.

X. CONCLUSION

Individuals seek bankruptcy relief because they want the benefits of discharge. However, not all claims are subject to discharge even where the debtor has conducted his or her affairs honestly and with integrity. The BC mandates that certain tax claims survive the debtor's bankruptcy case. These tax claims may be grouped in two broad categories: (1) those claims that Congress has determined must be paid as a matter of public policy regardless of debtor culpability; and (2) those claims that arise from debtor misconduct. Notwithstanding the curtailment of the discharge of taxes, many taxes are subject to discharge in an individual debtor chapter 7, chapter 11, or chapter 13 case. Moreover, since enactment of BAPCPA in 2005, the advantages to a chapter 13 bankruptcy case largely no longer exist. This is quite odd when a primary objective of BAPCPA was the encouragement of debtors to seek relief under chapter 13 instead of chapter 7.

The cross-disciplinary practice of bankruptcy law and tax law brings with it a host of challenging substantive and procedural issues. This practice cuts across federal, state, and local bodies of law. It requires you do become comfortable with working with the IRS and its maze of formal and informal procedures. Daunting yes, but fabulously rewarding. A commitment to understanding this intersection of the law will make you a better bankruptcy practitioner and arm you with the tools necessary to address your client's needs in a robust manner.

Faculty

Richard P. Carmody is a principal bankruptcy lawyer in the Birmingham, Ala., office of Adams and Reese LLP and has practiced law for more than 45 years. He specializes in insolvency law (C&I) and secured lending, and has a network of referral sources that he has developed throughout his career. Mr. Carmody is one of the firm's principal bankruptcy attorneys, representing clients in difficult financial matters. He also provides counsel to lenders for complex commercial transactions and internal policies. In 1992, Mr. Carmody became the first lawyer in Alabama to become Board Certified in Business Bankruptcy Law by the American Board of Certification. On the state level, he helped establish and served as the first chair of the Alabama State Bar section on bankruptcy and commercial law, and he was a member of the Alabama Law Institute's committees for revision of the UCC (Articles 3, 4, 4A, 5 and 9). Mr. Carmody is a founding member of ABI, and he established and co-chaired its Ethics Committee from 1999-2005. Additionally, he served as vice chair of the ABI's 2013 Task Force for Ethical Standards and was honored as ABI's Committee Member of the Year in 2012. Currently, he serves on ABI's Veterans Task Force. Mr. Carmody was inducted as a Fellow in the American College of Bankruptcy in 1999 and serves as a director of the College Foundation and as a member of its *pro bono* committee. He is a frequent writer and lecturer on bankruptcy and commercial law topics, and in 2017, the Alabama State Bar presented him with the Albert L. Vreeland Pro Bono Award. Mr. Carmody received his B.A. in finance in 1964 from the University of Illinois and his J.D. in 1975 from Vanderbilt University School of Law.

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