Chapter 13: Financial Distress

Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

ISSUE 1: BANKRUPTCY OVERVIEW

On April 20, 2005, President Bush signed into law the largest overhaul of the Bankruptcy Code since 1978. The act is known as the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005.[1] The majority of the BAPCPA provisions became effective on October 17, 2005.

Means Test

At the heart of the BAPCPA is a **means test** which is designed to force debtors who have the ability to pay some of their debts into Chapter 13 (reorganization) as opposed to liquidating under Chapter 7 and wiping the slate clean. Previously, the bankruptcy law allowed a Chapter 7 debtor fresh start relief unless the bankruptcy judge determined the debtor had committed substantial abuse in filing the bankruptcy petition. If substantial abuse occurred, the Chapter 7 case was dismissed, or with the debtor's consent, converted to Chapter 13.

The Act lowers the **substantial abuse** standard for dismissal or conversion to one of simple abuse. Whether abuse is presumed depends on the outcome of a means test that projects, over a 5-year period, the debtor's current monthly income, less specified expenses. Debtors whose net current monthly income exceeds their state's median income are subject to the test.

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1. Pub. L. No. 109-8

Census Bureau Median Family Income By Family Size[2]

		Family Size		
State	1 Earner	2 People	3 People	4 People[a]
Alaska	$45,012	$68,008	$72,382	$73,825
Arkansas	32,534	41,760	48,943	53,671
Connecticut	55,410	68,879	78,973	96,493
Florida	40,036	50,636	56,923	66,876
Illinois	44,673	56,545	66,607	77,634
Indiana	39,384	51,056	57,510	69,718
Iowa	37,759	50,581	59,331	69,723
Kansas	38,594	52,989	58,075	69,831
Maine	38,090	47,699	59,883	65,310
Michigan	43,123	51,878	61,796	74,658
Missouri	37,747	48,944	56,478	65,076
Montana	38,968	48,079	53,595	62,301
North Dakota	36,735	49,893	61,305	69,484
Pennsylvania	43,166	50,628	63,491	76,182
South Dakota	32,854	49,419	61,884	65,317
Washington	48,030	60,252	68,139	77,280
Wisconsin	41,528	54,297	65,440	74,560

[a] Add $6,900 for each individual in excess of 4.

Under the means test, a debtor at the low end of the income range is eligible for Chapter 7 relief if income (net of expenses) is less than $100 per month ($6,000 over five years). At the high end, a debtor is not eligible for Chapter 7 relief if net income is equal to or exceeds $166.67 per month ($10,000 over five years). In the middle are debtors with net monthly income of $100 to $166.66 ($6,000 to $9,999 over five years). If income less expenses multiplied by 60 is between $6,000 and $10,000, conversion or dismissal is only required if the debtor has sufficient income to pay 25% of nonpriority unsecured claims.

Thus, a debtor with net current monthly income in excess of his state's median income is subject to a means test. A **bright-line rule** for abuse is created requiring dismissal or conversion if:

1. The debtor had at least $166.67 in current monthly income **after** the allowed deductions, ($10,000 for five years) — abuse is presumed regardless of the debtor's unsecured debt; or
2. The debtor had at least $100 of such income ($6,000 for five years) — abuse is presumed if income is sufficient to pay at least 25% of the debtor's nonpriority unsecured debt over five years.

Example 1. Ima's income exceeds that of the state's median. After deducting allowed expenses, Ima has $150 net monthly income. She has $35,000 in unsecured, nonpriority debt. Ima satisfies the first prong of the means test because her net monthly income after deductions is less than $166.67. Over a 5-year period, Ima could repay $9,000 (60 × $150) of her unsecured debts. However, abuse would be presumed because Ima could repay at least 25% of $35,000 or $8,750. Therefore, Ima is ineligible for Chapter 7 relief.

The presumption of abuse can only be rebutted with detailed documentation of special circumstances requiring additional expenses or adjustment of current monthly total income for which there is no reasonable alternative.

2. www.usdoj.gov/ust/eo/bapcpa/20080317/bci_data/median_income_table.htm

Expenses

The BAPCPA strictly construes amounts that debtors can claim as expenses. Reasonable monthly living expenses are specified under IRS standards.[3] National standards establish allowances for food, clothing, personal care, and entertainment depending on the debtor's family size. Under means testing, if reasonable and necessary, debtors are allowed an increase of up to 5% on the food and clothing allowance. Local standards establish allowances for transportation on a regional basis and housing on a county by county basis. A third category entitled "other necessary expenses" is recognized by the IRS, although it does not specify an allowance.

The amount of plan payments is based on IRS allowances and other expenses. This excludes repayments of pension loans from pension plans and social security benefits. The plan payments are based on a 6-month average minus amounts necessary for the debtor's support. This includes amounts spent for all of the following:

- Post-petition domestic support obligations
- Charitable contributions up to 15% of gross income
- Public or private school expenses up to $1,500 annually per child per year subject to certain restrictions
- Protection from family violence
- Continued contributions to care for a nondependent family member
- Additional home energy costs
- $^1/_{60}$ of the arrearage of the debtor's mortgage on his residence, automobile and other property necessary for support

Note on Charitable Deductions. After enactment of the BAPCPA, some bankruptcy courts interpreted 11 USC §1325 in a manner that resulted in charitable contributions not being available as a deduction for above median income debtors while payments to creditors were still being made in a bankruptcy proceeding (Chapter 13).[4] However, the Congress recognized the issue and amended 11 USC §1325(b)(3) in the Religious Liberty and Charitable Donation Clarification Act of 2006 to allow such deductions. The amendment became law on December 20, 2006, as Pub. L. No. 109-439, 120 Stat. 3285. Accordingly, charitable contributions are not fraudulent transfers if the contribution amount does not exceed 15% of the debtor's gross annual income for the year in which the contribution is made, or if the contribution is in excess of such amount, it is consistent with the debtor's charitable contribution practices.

Property of the Bankruptcy Estate — Tax Aspects

The Bankruptcy Code defines property expansively. Almost anything owned by the debtor belongs to the bankruptcy estate at the time the petition is filed. In one case, the court held that the debtors' pre-bankruptcy application of their tax overpayment to the subsequent year's tax obligation did not mean that the asset was not property of their bankruptcy estate.[5] A different court held that the debtors' earned income credits are property of the estate even though they are contingent and not finalized until the end of the tax year.[6] Thus, refunds attributable to pre-petition portions of tax credits are included in the bankruptcy estate. Likewise, the debtor's right to carry forward or back a net operating loss (NOL) is considered property of the bankruptcy estate. Similarly, any tax refund that might result from a carryback of the NOL is property of the estate.[7]

3. IRS News Release IR-2007-163 (Oct. 1, 2007); IMRS 07-0000654
4. *In re Diagostino*, 347 B.R. 116 (Bankr. N.D. N.Y. 2006).
5. *Nichols v. Birdsell*, 491 F.3d 987 (9th Cir. 2007)
6. *In re Montgomery*, 224 F.3d 1193 (10th Cir. 2000). See also, *In re Johnston*, 209 F.3d 611 (6th Cir. 2000).
7. *In re Feiler*, 218 F.3d 948 (9th Cir. 2000)

TYPES OF BANKRUPTCY

This section contains descriptions of the four types of bankruptcy that a debtor can file. Each type of bankruptcy has requirements and outcomes at different stages. Below is a brief summary of these. More details are provided in the descriptions of each type of bankruptcy that follows.

Chapter	Taxpayer[a]	Pre-Petition Period	Post-Petition Period	Result
7 (liquidation)	Individuals, sole proprietors	Normal operations, Form 1040, Sch. C	Credit meeting; claim period, Form 1041	Discharge of debt
11 (reorganization)	Corporations, partnerships	Normal operations, Forms 1120 and 1065	Credit meeting; plan reorganization, Forms 1120 and 1065	Repay some or all
12 (reorganization)	Farmers, fishermen	Normal operations, Form 1040, Sch. F	Credit meeting; plan reorganization, Form 1040, Sch. F	Adjust debt to cash flow after familial needs
13 (reorganization)	Individuals, sole proprietors	Normal operations, Form 1040, Sch. C	Credit meeting; plan reorganization, Form 1040, Sch. C	Repay some or all

[a] Generally applies to these taxpayers.

Liquidation — Chapter 7

Debtors who cannot reorganize their debts, and who wish to be free of their obligations, may file for **liquidation bankruptcy.** This procedure is governed by Chapter 7 of the Bankruptcy Code and is known as **straight bankruptcy.** The debtor turns over all assets to the bankruptcy court, receives back the assets that are exempt from creditors, and obtains a discharge from all dischargeable debts.

Note. In any type of bankruptcy, an individual debtor may protect some property from the claims of creditors because it is exempt under federal bankruptcy law or under the laws of the debtor's home state.[8] Many states have taken advantage of a provision in the Bankruptcy Code that permits each state to adopt its own exemption law in place of the federal exemptions. In other jurisdictions, the individual debtor has the option of choosing between a federal package of exemptions or the exemptions available under state law. Therefore, whether certain property is exempt and may be kept by the debtor is often a question of state law. The debtor should consult an attorney to determine the exemptions available in the state where the debtor lives.

Nondischargeable Debts. Some debts are not dischargeable — largely on social policy grounds. Nondischargeable debts are set forth in 11 USC §523. These debts are nondischargeable in any type of bankruptcy:

- Debts for certain types of taxes;
- Debts for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by false pretenses, false representation, actual fraud, or false financial statements;
- Consumer debts owed to a single creditor and aggregating more than $500 for luxury goods (e.g., goods that are not necessary for the support or maintenance of the debtor or a debtor's dependent), or services incurred by an individual debtor on or within 90 days before bankruptcy filing;

8. 11 USC §522(b)

- Debts for cash advances aggregating more than $750 that are extensions of consumer credit under an open-end credit plan obtained by an individual debtor on or within 70 days before bankruptcy filing;
- Debts that the debtor fails to list in the bankruptcy schedules;
- Debts arising from fraud while acting in a fiduciary capacity, embezzlement, or larceny;
- Debts for alimony and child support, and other obligations arising out of divorce or separation;
- Debts arising from willful and malicious injury by the debtor to someone else's property;
- Student loans;
- Restitution orders;
- Debts arising from death or personal injury caused by the debtor's operation of a motor vehicle while the debtor was intoxicated or under the influence of other drugs that are illegal;
- Debts owed to a pension, profit-sharing, stock bonus, or other plan established under certain sections of the Code; and
- Debts for homeowner association, condominium and cooperative fees.

Some debtors, because of their conduct, may not be eligible for discharge. A discharge may be denied for a debtor who:

1. Fraudulently transferred, destroyed, or concealed property within one year before the petition was filed, or as to property of the estate after the petition was filed;
2. Unjustifiably concealed, destroyed, falsified, or failed to keep records;
3. Knowingly or fraudulently gave a false oath or account;
4. Failed to satisfactorily explain a loss or deficiency of assets;
5. Refused to obey a court order; or
6. Committed any of the previous items listed in connection with a case concerning an insider within a year of filing the bankruptcy petition.

Initiating a Chapter 7 Case. A Chapter 7 case is initiated by filing a voluntary petition and paying a $299 filing fee (effective April 9, 2006). The Department of Justice then appoints a bankruptcy trustee (U.S. trustee).

Qualification. To qualify for relief under Chapter 7, the debtor may be an individual, a partnership, a corporation, or other business entity.[9] Subject to the means test, Chapter 7 is available irrespective of the amount of the debtor's debts or whether the debtor is solvent or not.

An individual cannot file under Chapter 7 or any other Chapter, if:

1. During the preceding 180 days, a prior bankruptcy petition was dismissed due to the debtor's willful failure to appear before the court or comply with orders of the court;
2. The debtor voluntarily dismissed the previous case after creditors sought relief from the bankruptcy court to recover property upon which they hold liens;
3. The debtor has not received credit counseling from an approved credit counseling agency either in an individual or group briefing within 180 days before filing; or
4. The debtor has received a bankruptcy discharge in a Chapter 7 or 11 proceeding within eight years of the date of filing a new bankruptcy petition (six years for Chapter 12 or 13).[10]

9. 11 USC §§101(41) and 109(b)
10. 11 USC §727(a)(8-9)

> **Note.** No individual may be a debtor under Chapter 7 or any chapter of the Bankruptcy Code if credit counseling is not completed within 180 days before filing. Exceptions apply in emergency situations.[11]

Filing the Petition. A Chapter 7 case begins with the debtor filing a petition with the bankruptcy court serving the area where the individual lives. For businesses, it is filed where the business debtor is organized, has its principal place of business or principal assets.

In addition to the petition, the debtor must also file the following with the court:

- Schedules of assets and liabilities,
- Schedule of current income and expenditures,
- Schedule of exempt assets,
- Statement of financial affairs, and
- Schedule of executory contracts and unexpired leases.[12]

Debtors must also provide the bankruptcy trustee with a copy of the tax return or transcripts for the most recent tax year and tax returns filed during the case. This includes tax returns for prior years that had not been filed when the case began.

Individual debtors with primarily consumer debts have additional document filing requirements. They must file:

- A certificate of credit counseling and a copy of any debt repayment plan developed through credit counseling;
- Evidence of payment from employers received 60 days before filing;
- A statement of monthly net income, and any anticipated increase in income or expenses after filing; and
- A record of any interest the debtor has in federal or state qualified education or tuition accounts.

> **Note.** A husband and wife may file joint or individual petitions. Even if filing jointly, a husband and wife are subject to all the document filing requirements of individual debtors.

Reorganization — Chapter 11

Chapter 11 bankruptcy provides for reorganization, usually involving a corporation or partnership. A Chapter 11 debtor usually proposes a plan of reorganization to keep its business alive and pay creditors over time. Sole proprietorships and individuals can also file Chapter 11. An individual debtor is subject to the same credit counseling requirement as Chapter 7 filers. The filing fee is currently $1,039 (as of April 9, 2006) and may be paid in a maximum of four monthly installments.

Chapter 11 is typically used to reorganize a business, which may be a corporation, sole proprietorship, or partnership. The Chapter 11 filing of a corporate debtor does not put the personal assets of the stockholders at risk, other than the value of their investment in the company's stock. A sole proprietorship as debtor, however, includes both the business and personal assets of the owners-debtors. For a partnership debtor, the partners' personal assets may, in some cases, be used to pay creditors in the bankruptcy case, or the partners may be forced to file for bankruptcy protection.

> **Note.** In a Chapter 11 filing, the debtor in possession essentially performs all the functions and duties of a trustee, including the filing of tax returns.

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11. 11 USC §§109, 111. Exceptions apply in emergency situations or when the bankruptcy trustee determines that there are insufficient approved agencies to provide the required counseling. If a debt management plan is developed during required credit counseling, it must be filed with the court.

12. Fed. R. Bankr. P. 1007(b)

The Creditors' Committee. In a Chapter 11 bankruptcy, a creditors' committee is established. The committee is appointed by the U.S. trustee and ordinarily consists of unsecured creditors who hold the seven largest unsecured claims against the debtor. Among other things, the committee:

- Consults with the debtor in possession on administration of the case;
- Investigates the debtor's conduct and operation of the business; and
- Participates in formulating a plan.

A creditors' committee may, with the court's approval, hire an attorney or other professionals to assist in the performance of the committee's duties. In short, the committee can be an important safeguard to the proper management of the business by the debtor in possession. However, in smaller cases, the U.S. trustee may be unable to find creditors willing to serve on a creditors' committee, or the committee may not be actively involved in the case. In these situations, a small business case may be created if the debtor is engaged in commercial or business activities. These are activities other than primarily owning or operating real property.

The Reorganization Plan. The debtor (unless it is a small business debtor) has a 120-day period during which it has an exclusive right to file a plan. The period may be extended (such that the exclusivity period does not exceed 18 months) or it may be reduced by the court. After the exclusivity period expires, a creditor or the case trustee may file a competing plan. The U.S. trustee may not file a plan.

A Chapter 11 case may continue for many years unless the court, the U.S. trustee, the committee, or another party with interest acts to ensure the case's timely resolution. The creditors' right to file a competing plan provides incentive for the debtor to file a plan within the exclusivity period. This serves as a check on excessive delay in the case.

Plan Confirmation and Modification. Confirmation of the reorganization discharges any type of debtor — corporation, partnership, or individual — from most types of pre-petition debts. However, it does not discharge an individual debtor from any debts that are nondischargeable. Furthermore, except in limited circumstances, a discharge is not available to an individual debtor unless (and until) all payments are made under the plan. Confirmation does not discharge the debtor if the plan is a liquidation plan, as opposed to one of reorganization, unless the debtor is an individual. When the debtor is an individual, confirmation of a liquidation plan results in a discharge (after plan payments are made). This occurs unless grounds exist for denying the debtor a discharge if the case was proceeding under Chapter 7 instead of Chapter 11.

At any time after confirmation and before substantial consummation of a plan, the proponent of a plan may modify the plan if the modified plan meets certain Bankruptcy Code requirements.[13] A modified postconfirmation becomes the plan only if:

- The debtor's circumstances warrant the modification, and
- After notice and hearing, the court confirms the plan as modified.

If the debtor is an individual, the plan may be modified postconfirmation upon the request of the debtor, the trustee, the U.S. trustee, or the holder of an allowed unsecured claim to make adjustments to payments due under the plan.

13. 11 USC §1127(b)

Reorganization — Chapter 12

Chapter 12 is designed for family farmers or family fishermen with regular annual income. It enables financially-distressed family farmers and fishermen to propose and carry out a plan to repay all or part of their debts. Under Chapter 12, debtors propose a repayment plan to make installments to creditors over three to five years. Generally, the plan must provide for payments over three years, unless the court approves a longer period for cause. However, unless the plan proposes to pay 100% of domestic support claims (i.e., child support and alimony) if any exist, it must be for five years and must include all the debtor's disposable income. In no case may a plan provide for payments over a period longer than five years.

Observation. In tailoring bankruptcy law to meet the economic realities of family farming and fishing, Chapter 12 eliminates many of the barriers such debtors would face if seeking to reorganize under either Chapter 11 or 13. Chapter 12 is more streamlined, less complicated, and less expensive than Chapter 11, which is better suited to large corporate reorganizations. Likewise, few family farmers or fishermen find Chapter 13 advantageous because it is designed for wage earners who have smaller debts than those facing family farmers. In Chapter 12, Congress sought to combine the features of the Bankruptcy Code in order to provide a framework for successful family farmer and fisherman reorganizations.

Eligible Debtors. Only a family farmer or family fisherman with **regular annual income** may file a petition for relief under Chapter 12. The purpose of this requirement is to ensure that the debtor's annual income is sufficiently stable and regular to permit the debtor to make payments under a Chapter 12 reorganization plan. Allowances are made for situations in which family farmers or fishermen have income that is seasonal in nature.

Note. Relief under Chapter 12 is voluntary, and only the debtor may file a petition.

Under Chapter 12, family farmers and family fishermen fall into two categories:

1. An individual, or individual and spouse, or
2. A corporation or partnership.

Farmers or fishermen falling into the first category must meet each of the following four criteria as of the petition's filing date in order to qualify for relief under Chapter 12:

- The individual, or husband and wife must be engaged in a farming operation or a commercial fishing operation.
- The total debts (secured and unsecured) of the operation must not exceed $3,544,525 (if a farming operation) or $1.5 million (if a commercial fishing operation).
- A percentage of the total debts that are fixed in amount (exclusive of debt for the debtor's home) must be related to the farming or commercial fishing operation. For farmers, this is 50%. For fishermen, this is 80%.
- More than 50% of the preceding year's gross income of the individual, or the husband and wife (or, for family farmers only, for each of the second and third prior tax years) must have come from the farming or commercial fishing operation.

In order for a corporation or partnership to fall within the second category, it must meet each of the following criteria as of the petition's filing date:

- More than half the outstanding stock or equity in the corporation or partnership must be owned by one family, or by one family and its relatives.
- The family or the family and its relatives must conduct the farming or commercial fishing operation.
- More than 80% of the value of the corporate or partnership assets must be related to the farming or fishing operation.

- The total indebtedness of the corporation or partnership must not exceed $3,544,525 (if a farming operation) or $1.5 million (if a commercial fishing operation).
- A percentage of the corporation's or partnership's total debts which are fixed in amount (exclusive of debt for one home occupied by a shareholder) must be related to the farming or fishing operation. For a farming operation, this is 50%. For a fishing operation, it is 80%.
- If the corporation issues stock, the stock cannot be publicly traded.

Note. The BAPCPA's credit counseling requirements also apply to Chapter 12 reorganizations.

Filing the Petition. The fee for filing a Chapter 12 petition is currently $239, and can be paid in up to four monthly installments with the court's permission. The debtor must also file a schedule of assets and liabilities, a schedule of current income and expenditures, a schedule of executor contracts and unexpired leases, and a statement of financial affairs. A married couple may file a joint petition.

Note. The schedules filed with the court must detail all of the debtor's creditors and the amounts and nature of each claim; the source, amount and frequency of the debtor's income; a detailed list of all of the debtor's property; and a detailed list of the debtor's monthly farming income and living expenses (food, shelter, utilities, taxes, transportation, medicine, feed, fertilizer, etc.). This detailed information must be filed for **each** spouse even if only one spouse is filing the petition.

When a Chapter 12 petition is filed, a trustee is appointed to administer the case. As with other bankruptcy chapters, filing a Chapter 12 petition automatically stops (stays) most collection actions against the debtor or the debtor's property. This action arises by operation of law and requires no judicial action. As long as the stay is in effect, creditors generally cannot initiate or continue any lawsuits, wage garnishments, or even telephone calls demanding payments.

Note. Chapter 12 also contains a special automatic stay provision that protects co-debtors. Unless the bankruptcy court authorizes otherwise, a creditor may not seek to collect a consumer debt from any individual who is liable along with the debtor. Consumer debts are those incurred by an individual primarily for a personal, family or household purpose.

Creditors' Meeting. In general, a meeting of creditors is held between 20 and 35 days after the petition is filed. The debtor must attend the meeting and answer questions regarding the debtor's financial affairs and the proposed terms of the debtor's repayment plan. For joint petitions, both spouses must attend the creditors' meeting. To participate in distributions from the bankruptcy estate, unsecured creditors must file their claims with the court within 90 days after the first date set for the meeting of creditors. A governmental unit has 180 days from the case's filing date to file a proof of claim.

After the creditors' meeting, the debtor, the Chapter 12 trustee, and interested creditors attend a hearing on confirmation of the debtor's Chapter 12 repayment plan.

The Reorganization Plan. Unless the court grants an extension, the debtor must file a repayment plan with the petition or within 90 days after filing the petition. The plan, which must be submitted to the court for approval, provides for payments of fixed amounts to the trustee on a regular basis. The trustee then distributes the funds to creditors according to the terms of the plan, which typically offers creditors less than full payment on their claims.

There are two types of claims — secured and unsecured. Secured claims are those for which the creditor has the right to liquidate certain property if the debtor does not pay the underlying debt, and unsecured claims are generally those for which the creditor has no special rights to collect against particular property owned by the debtor. Unsecured claims are classified and paid based on a priority list contained in 11 USC §507.

> **Note.** In a Chapter 12 reorganization, all governmental claims arising from the sale, exchange, or other disposition of the debtor's property are treated as unsecured claims.

A Chapter 12 plan usually lasts three to five years and must provide for full payment of all priority claims, unless a priority creditor agrees to different treatment of the claim or, in the case of a domestic support obligation, unless the debtor contributes all "disposable income" to a 5-year plan. Under the terms of the plan, secured creditors must be paid at least as much as the value of the collateral pledged for the debt.

> **Note.** In a Chapter 12 bankruptcy, payments to secured creditors can sometimes continue longer than the 3-to-5 year period of the plan. This allows, for example, a farmer to continue to pay off an equipment loan over the original loan repayment schedule as long as any arrearage is made up during the plan.

The plan need not pay unsecured claims in full, as long as it commits all the debtor's projected disposable income (or property of equivalent value) to plan payments over a 3-to-5 year period. Also, the unsecured creditors must receive at least as much as they would receive if the debtor's nonexempt assets were liquidated under Chapter 7. Disposable income is defined as income not reasonably necessary for the maintenance or support of the debtor or dependents, or for making payments needed to continue, preserve, and operate the debtor's business.

Plan Confirmation. Within 45 days after the plan is filed, the court determines whether the plan is feasible and whether it can be confirmed. If the court confirms the plan, the Chapter 12 trustee distributes funds received in accordance with the terms of the plan. If the court does not confirm the plan, the debtor may file a modified plan. The debtor may also convert the case to a liquidation plan under Chapter 7. If the debtor fails to confirm a plan and the case is dismissed, the court may authorize the trustee to keep some of the funds for costs, but the trustee must return all remaining funds to the debtor (other than funds already disbursed to creditors).

On occasion, changed circumstances will affect the debtor's ability to make plan payments. A creditor may object or threaten to object to a plan, or the debtor may inadvertently fail to list all creditors. In such instances, the plan may be modified either before or after confirmation. Modification after confirmation is not limited to the debtor's initiative, but may also be made at the request of the trustee or an unsecured creditor.

> **Note.** See Chapter 14, "Agricultural Issues and Rural Investments," for further discussion of Chapter 12 bankruptcy issues.

Reorganization — Chapter 13

A Chapter 13 bankruptcy enables individuals with regular income to develop a plan to repay all or part of their debts. With a Chapter 13 bankruptcy, debtors propose a repayment plan to make installments to creditors over three to five years. If the debtor's current monthly income is less than the applicable state median, the plan will be for three years unless the court approves a longer period for cause. If the debtor's current monthly income is greater than the applicable state median, the plan generally must be for five years. In no case may a plan provide for payments over a period longer than five years. During this time the law forbids creditors from starting or continuing collection efforts.

Chapter 13 reorganization has several advantages over a Chapter 7 liquidation:

- Chapter 13 filers may be able to save their homes from foreclosure by acquiring additional time to cure delinquent mortgage payments.
- Chapter 13 filers may reschedule secured debts (other than a mortgage for their primary residence) and extend them over the life of the Chapter 13 plan, which may result in reduced payments.
- Chapter 13 also has a special provision that protects third parties who are liable with the debtor on consumer debts.
- Chapter 13 acts like a consolidation loan under which the individual makes the plan payments to a Chapter 13 trustee who then distributes payments to creditors. Individuals have no direct contact with creditors while under Chapter 13 protection.

Eligibility. Any individual, even if self-employed or operating an unincorporated business, is eligible for Chapter 13 relief as long as the individual's unsecured debts are less than $336,900 and secured debts are less than $1,010,650 (as of April 1, 2007). Chapter 13 filers must participate in credit counseling as required by the BAPCPA.

> **Note.** There are some significant differences between a Chapter 11 and a Chapter 13 bankruptcy. For example, there is no debt limit in a Chapter 11 bankruptcy, and a corporation or partnership may not be a Chapter 13 debtor.

Filing the Petition. Similar to other bankruptcies, a Chapter 13 debtor must file the necessary schedules with the court detailing the debtor's assets and liabilities, income and expenses, schedules of executory contracts and unexpired leases, and statement of financial affairs. The debtor must undergo credit counseling as required by the BAPCPA. The debtor must also provide the Chapter 13 trustee with a copy of the tax return or transcripts for the most recent tax year and the tax returns filed during the case (including tax returns for prior years that had not been filed when the case began). A husband and wife may file a joint petition or individual petitions.

The Chapter 13 filing fee is currently $274 and can be paid in up to four monthly installments.

As with other types of bankruptcy filings, filing a Chapter 13 petition automatically stops (stays) most collection actions against the debtor or the debtor's property. Chapter 13 also contains a special automatic stay provision that protects co-debtors. Unless the bankruptcy court authorizes otherwise, a creditor may not seek to collect a consumer debt from any individual who is liable along with the debtor. Consumer debts are those incurred by an individual primarily for a personal, family, or household purpose.

Creditors' Meeting. Between 20 and 50 days after the debtor files the Chapter 13 petition, the trustee holds a meeting of creditors. The debtor must attend the meeting and answer questions regarding the debtor's financial affairs and the proposed terms of the plan. If a husband and wife file a joint petition, they both must attend the creditors' meeting and answer questions. The parties typically resolve problems with the plan either during or shortly after the creditors' meeting. Generally, the debtor can avoid problems by making sure that the petition and plan are complete and accurate and by consulting with the trustee prior to the meeting.

After the creditors' meeting, the debtor, the trustee, and those creditors who wish to attend will go to court for a hearing on the debtor's Chapter 13 repayment plan.

The Reorganization Plan. Unless the court grants an extension, the debtor must file a repayment plan with the petition, or within 15 days after the petition is filed. A plan must be submitted for court approval and must provide for payments of fixed amounts to the trustee on a regular basis, typically biweekly or monthly. The trustee then distributes the funds to creditors according to the terms of the plan, which may offer creditors less than full payment on their claims.

The plan must pay priority claims in full unless a particular priority creditor agrees to different treatment of the claim or, in the case of a domestic support obligation, unless the debtor contributes all disposable income to a 5-year plan.

If the debtor wants to keep the collateral securing a particular claim, the plan must provide that the holder of the secured claim receive at least the value of the collateral. If the obligation underlying the secured claim was used to buy the collateral (e.g., a car loan), and the debt was incurred within certain time frames before the bankruptcy filing, the plan must provide for full payment of the debt, not just the value of the collateral (which may be less due to depreciation). Payments to certain secured creditors (i.e., the home mortgage lender) may be made over the original loan repayment schedule (which may be longer than the plan) as long as any arrearage is made up during the plan. The debtor should consult an attorney to determine the proper treatment of secured claims in the plan.

The plan need not pay unsecured claims in full as long as it provides that the debtor will pay all projected disposable income over an applicable commitment period, and as long as unsecured creditors receive at least as much under the plan as they would receive if the debtor's assets were liquidated under Chapter 7. In Chapter 13, disposable income is income (other than child support payments received by the debtor) less amounts reasonably necessary for the maintenance or support of the debtor or dependents, less charitable contributions up to 15% of the debtor's gross income. If the debtor operates a business, the definition of disposable income excludes those amounts necessary for ordinary operating expenses. The applicable commitment period depends on the debtor's current monthly income. The applicable commitment period must be three years if current monthly income is less than the state median for a family of the same size. It must be five years if the current monthly income is greater than the median for a family of the same size. The plan may specify less than the applicable commitment period (three or five years) only if unsecured debt is paid in full over a shorter period.

Within 30 days after filing the bankruptcy plan, even if the plan has not yet been approved by the court, the debtor must start making plan payments to the trustee. If any secured loan payments or lease payments come due before the debtor's plan is confirmed (typically home and automobile payments), the debtor must make adequate protection payments directly to the secured lender or lessor — deducting the amount paid from the amount that would otherwise be paid to the trustee.

Plan Confirmation. No later than 45 days after the creditors' meeting, the bankruptcy judge must hold a confirmation hearing and decide whether the plan is feasible and meets the standards for confirmation set forth in the Bankruptcy Code. Creditors receive 25 days notice of the hearing and may object to confirmation. While a variety of objections may be made, the most frequent ones are that payments offered under the plan are less than creditors would receive if the debtor's assets were liquidated, or that the debtor's plan does not commit all the debtor's projected disposable income for the three or five year applicable commitment period.

If the court confirms the plan, the Chapter 13 trustee distributes funds received under the plan as soon as is practicable. If the court declines to confirm the plan, the debtor may file a modified plan. The debtor may also convert the case to a liquidation case under Chapter 7. If the court declines to confirm the plan or the modified plan and instead dismisses the case, the court may authorize the trustee to keep some funds for costs, but the trustee must return all remaining funds to the debtor (other than funds already disbursed or due to creditors).

Discharge. The debtor is entitled to a discharge upon completion of all payments under the Chapter 13 plan as long as the debtor:

- Certifies that all domestic support obligations that came due prior to making such certification have been paid,
- Has not received a discharge in a prior case filed within a certain timeframe,
- Has completed an approved course in financial management, and
- Has no adversary complaint.

The court does not enter the discharge until it determines, after notice and a hearing, that there is no reason to believe there is any pending proceeding that might give rise to a limitation on the debtor's homestead exemption.

As a general rule, the discharge releases the debtor from all debts provided for by the plan or disallowed, except:

- Debts for alimony or child support,
- Certain taxes,
- Debts for most government funded or guaranteed educational loans or benefit overpayments,
- Debts arising from death or personal injury caused by driving while intoxicated or under the influence of drugs, and
- Debts for restitution or a criminal fine included in a sentence on the debtor's conviction of a crime.

Note. The discharge in a Chapter 13 bankruptcy is broader than in Chapter 7. Debts dischargeable in Chapter 13, but not in Chapter 7, include debts for willful and malicious injury to property (as opposed to person), debts incurred to pay nondischargeable tax obligations, and debts arising from property settlements in divorce or separation proceedings.

INCOME TAXATION IN BANKRUPTCY

For individuals under Chapter 12 or Chapter 13 bankruptcy, and for partnerships and corporations under all bankruptcy chapters, the debtor continues to be responsible for the income tax consequences of business operations and disposition of the debtor's property. However, for individuals under Chapter 7 or Chapter 11 bankruptcy, a new tax entity called the bankruptcy estate is created when the bankruptcy is filed.

The creation of the bankruptcy estate as a new taxpayer, separate from the debtor, highlights the five categories of taxes in a Chapter 7 or 11 case, as illustrated in the following table:

Category	Who Owes the Tax	Dischargeable or Not?
1 Taxes more than 3 years back assessed more than 240 days prior to filing petition.	Debtor	Dischargeable
2 Taxes within last 3 years	Debtor	Priority claim, but not dischargeable
3 Taxes in first short year January 1 to day before date of filing	Debtor	Priority claim, but not dischargeable
4 Taxes paid as administrative expenses in bankruptcy Date of filing through December 31	Bankruptcy estate	Not dischargeable
5 Taxes in second short year Date of filing through December 31	Bankruptcy estate	Not dischargeable

Categories of Taxes

Category 1 taxes are those that were **due** more than three years before the filing.[14] These taxes are dischargeable unless the debtor failed to file a return or filed a fraudulent return.

Category 2 taxes are those that were due within the last three years. These taxes are not dischargeable. They are entitled to an eighth priority claim in the bankruptcy estate, ahead of the unsecured creditors.

Category 3 taxes are those due for the portion of the year of bankruptcy filing up to the day before the day of bankruptcy filing. If the debtor's year is closed as of the date of filing, the taxes for the first year, while not dischargeable, are also entitled to an eighth priority claim in the bankruptcy estate. If the debtor's year is not closed, the entire amount of tax for the year of filing is the debtor's responsibility.

Category 4 taxes are those triggered on or after the date of filing and are the responsibility of the bankruptcy estate. Taxes due are paid by the bankruptcy estate as an administrative expense. If the taxes exceed the available funds, the tax obligation remains against the bankruptcy estate and does not return to the debtor.

Category 5 taxes are those assessed for the portion of the year beginning with the date of bankruptcy filing (or for the entire year if the debtor's year is not closed) and are the responsibility of the debtor.

Election to Close the Debtor's Tax Year

In general, the bankrupt debtor's tax year does not change upon filing for bankruptcy. However, debtors having nonexempt assets may elect to end the debtor's year as of the day before the bankruptcy filing. Making the election creates two short tax years for the debtor. The first short year ends the day before the bankruptcy filing and the second year begins with the bankruptcy filing date and ends on the bankrupt debtor's normal yearend date. If the election is not made, the debtor remains individually liable for income taxes for the year of filing. However, if the election is made, the debtor's income tax liability for the first short year is treated as a priority claim against the bankruptcy estate, and can be collected from the estate if there are sufficient assets to pay the estate's debts. If the assets are insufficient to pay the income tax, the remaining tax liability is not dischargeable, and the tax can be collected from the debtor at a later time.

The election is made by filing a Form 1040 for the first short period. The return is due on or before the 15th day of the fourth full month following the date of the bankruptcy petition. For example, if the taxpayer files the petition on February 7, the return is due on or before June 15.

To expedite the return's processing, "Section 1398 Election" should be written at the top of the return. Taxpayers may also file Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Tax Return,* and request an automatic extension of time to file the return.

Note. This timely election can be financially significant to the debtor.

The income tax owed by the bankrupt debtor for the **years ending after the filing** is paid by the debtor and not the bankruptcy estate. If an NOL, unused credits, or excess deductions are projected for the first short year, an election should not be made in the interest of preserving the loss for application against the debtor's income from the rest of the taxable year. Consequently, closing the debtor's tax year can be particularly advantageous if the debtor has substantial income in the period before the bankruptcy filing. Even if the debtor projects an NOL, has unused credits or anticipates excess deductions, the debtor may want to close the tax year as of the day before bankruptcy filing if the debtor will not likely be able to use the amounts. The items can then be used by the bankruptcy estate as a carryback to earlier years of the debtor (or as a carryforward), and the debtor will likely benefit later from the bankruptcy estate's use of the loss, deduction or credits.

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14. *In re Reine,* 301 B.R. 556 (Bankr. W.D. Mo. 2003) (bankruptcy petition filed more than three years after filing tax return, but within three years of due date of return; tax debt not dischargeable).

If the debtor does not act to end the tax year, none of the debtor's income tax liability for the year of bankruptcy filing can be collected from the bankruptcy estate. Likewise, if the short year is not elected, the tax attributes (including the basis of the debtor's property) pass to the bankruptcy estate as of the beginning of the debtor's tax year. For example, no depreciation may be claimed by the debtor for the period before bankruptcy filing. That could be a significant issue for many agricultural debtors.

Example 2. Sam is a cash-method taxpayer. On January 26, 2008, he bought and placed in service in his farming business a new combine that cost $402,000. Sam plans to elect to claim $102,000 of expense-method depreciation on the combine, an additional $150,000 (50% of the remaining depreciable balance) of first-year bonus depreciation, and regular depreciation on the combine for 2008. During 2008, Sam's financial condition severely worsened due to a combination of market and weather conditions. As a result, Sam filed Chapter 7 bankruptcy on December 5, 2008.

If Sam does not elect to close the tax year, the tax attributes (including the basis of property) pass to the bankruptcy estate as of the beginning of Sam's tax year (January 1, 2008). Therefore, Sam could not claim any of the depreciation for the period before he filed bankruptcy (January 1, 2008, through December 4, 2008).

Tax Attributes

If the debtor acts to end the tax year (which must be done with the filing of the tax return for the first short year), the debtor's tax attributes pass to the bankruptcy estate at the time of filing. The tax attributes include NOL carryovers, credit carryovers and capital loss carryovers. They also include features associated with the debtor's property, including income tax basis figures. In the event the debtor does not act to end the year, the tax attributes pass to the bankruptcy estate as of the beginning of the debtor's year (usually January 1). Obviously, the decision to close the year carries extremely important tax consequences.

Bankruptcy Estate. The transfer of property to the bankruptcy estate does not trigger adverse tax consequences. The estate claims income, deductions, and credits as if the debtor had continued in the same business.

The administrative expenses of bankruptcy are allowed as deductions in the bankruptcy estate.

The bankruptcy estate is allowed one personal exemption. It is allowed the deductions of an individual and the basic standard deduction. It is taxed at the rates applicable to a married taxpayer filing separately.

An income tax return, Form 1041, *U.S. Income Tax Return for Estates and Trusts*, must be filed by the trustee or debtor in possession if gross income exceeds the exemption amount plus the basic standard deduction ($8,950 in 2008).

Abandonment. As discussed earlier in this chapter, if any item of property passing into the bankruptcy estate is worth less than what is owed on it, the trustee may abandon the property back to the debtor. The secured creditor is then free to remove the property from the debtor through foreclosure or otherwise to satisfy the debt owed to the secured creditor.

A major concern is whether the bankruptcy estate or the debtor pays the resulting income tax liability. The majority of courts that considered this issue ruled that the debtor is responsible for the tax.[15]

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15. *In re A.J. Lane & Co.*, 133 BR 264 (U.S. Bank D. Mass., 1991) (bankruptcy estate bears responsibility for tax on abandonment); *In re Olson*, 930 F.2d.6 (1991) (debtor bears responsibility for tax on abandonment)

ISSUE 2: MORTGAGE FORECLOSURE TAX ISSUES

Numerous factors contributed to the current problems in the mortgage and housing industries. In large part, many of the problems stem from home buyers, mortgage companies and investors making bad decisions, and either not understanding or misusing some of the new and valuable financial innovations that have become available in recent years. This includes homeowners borrowing on their home's equity at a sum greater than the home's value, lenders providing loans to individuals with poor credit, and borrowers using loans to "fix and flip" houses with the expectation that the real estate market would continue to make the ventures profitable. Consequently, credit and housing markets are going through a period of painful adjustment, with the result that some homeowners face foreclosure.

Observation. Mortgage foreclosure may only be part of a taxpayer's overall financial problem. Thus, the practitioner should examine the client's entire financial and tax situation to determine if other tax issues associated with the taxpayer's financial distress exist. Other major items include:

1. Utilization of tax strategies that result in income bunching that now must be reported and require tax to be paid;
2. Utilization of rapid depreciation techniques on property that now must be sold as a result of financial distress;
3. Cancellation of an installment sale arrangement entered into by family members; and
4. The relinquishing of property to a lender in return for the discharge of debt.

Foreclosure can result in unexpected tax consequences to the debtor. The precise impact depends on the type of debt involved, state law, and whether the foreclosure is structured as a short sale. In addition, mortgage foreclosure can have tax consequences to the lender.

Note. On September 17, 2007, the IRS issued a news release announcing that it had added to its website a frequently asked questions (FAQ) section devoted to tax issues for taxpayers who lose their homes due to foreclosure.[16] In the news release, the IRS reassured homeowners that while mortgage workouts and foreclosures can have tax consequences, special relief provisions exist to reduce or eliminate the tax bite for financially strapped taxpayers who lose their homes. In addition, there may be viable alternatives to foreclosure that don't carry the same negative tax consequences.

16. IRS New Release 2007-159 (September 17, 2007)

TAX CONSEQUENCES TO THE DEBTOR

Classification of the Indebtedness

An important part of debt resolution is the income tax consequences to the debtor. Gross income generally includes all income from whatever source derived.[17] This includes cancellation of debt income (CODI).[18]

When a foreclosure occurs, there are two distinct categories of income tax consequences:

- Gain or loss if the property is transferred to the lender in satisfaction of indebtedness; and
- Possible CODI to the extent debt discharged exceeds the FMV of the property the debtor gives up.

As a starting point, the tax impact of mortgage foreclosure is heavily dependent on the type of debt involved. If the **debt is recourse,** the collateral serves as security on the loan. If the collateral is insufficient to satisfy the loan on the foreclosure, the debtor is personally liable on the obligation and the debtor's nonexempt assets are reachable to satisfy any deficiency. If the **debt is nonrecourse,** the collateral serves as security on the loan. However, if the collateral's value is less than the balance on the debt, the debtor is not personally liable for the balance. Therefore, the creditor must look solely to the collateral in the event of default.

> **Note.** State law determines the type of indebtedness involved. In many states, home mortgages are classified as recourse debt. However, California treats mortgages that are used to purchase a residence as nonrecourse, although mortgages related to refinancing a previous mortgage are usually recourse.

Nonrecourse Debt. When a nonrecourse mortgage is foreclosed, the property is treated as being sold for the balance of the mortgage.[19] Thus, the entire difference between the income tax basis of the property (that is transferred to the creditor) and the amount of the debt discharged is gain or loss. There is no CODI. One significant difference between nonrecourse and recourse mortgages is that with a nonrecourse mortgage, the amount realized on foreclosure, or a transfer in lieu of foreclosure, is never less than the outstanding debt.[20] Consequently, the debt is not treated as "cancelled'' and the debtor does not have CODI.

> **Note.** In the IRS FAQ, No. 3, the IRS incorrectly states that CODI is "not taxable in the case of nonrecourse loans." The correct statement should be that foreclosure of a nonrecourse loan does not result in CODI.

Recourse Debt. The income tax consequence of foreclosure of a recourse mortgage is treated as if the property is sold to the creditor with the sale proceeds applied to the debt. In this situation, a 2-step process is involved:

1. There is no gain or loss (and no other income tax consequence) up to the income tax basis on the property. The difference between FMV and the income tax basis is gain or loss;[21] and
2. If the indebtedness exceeds the property's FMV, the difference is CODI.[22]

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17. IRC §61(a)
18. IRC §61(a)(12). Under IRC §1001(a), gain realized from the sale of property equals the excess of the amount realized over the taxpayer's adjusted income tax basis in the property. The amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.
19. *Comm'r v. Tufts,* 461 U.S. 300 (1983), *rev'g, sub. nom., Tufts v. Comm'r,* 651 F.2d 1058 (5th Cir. 1981); *Helvering v. Hammel,* 311 U.S. 504 (1941)
20. IRC §7701(g)
21. *Emmons v. Comm'r,* TC Memo 1998-173 (May 11, 1998)
22. Treas. Reg. §1.1001-2(a)(1)

Consequently, the foreclosure of a recourse mortgage (as well as a transfer as a result of an agreement between the parties) is treated as a sale up to the point of the property's FMV.[23] If the lender forgives the balance of the mortgage, then that amount is CODI and it is taxed at ordinary income rates.[24]

For recourse debt, the tax consequences of mortgage foreclosure are heavily dependent on a determination of the property's FMV. Determining exactly what the property's FMV is may not be an easy task. If the taxpayer surrenders property to a creditor in exchange for cancellation of debt in a foreclosure sale, absent clear and convincing proof to the contrary, the FMV is presumed to be the sale price at the foreclosure sale.[25]

Note. Unless a taxpayer rebuts this presumption, the amount bid at the foreclosure sale is deemed the property's FMV. Lenders frequently bid an amount higher than the property's FMV. A taxpayer in an appropriate case should obtain appraisal evidence at the time of sale if the property's value is less than the amount bid at foreclosure.[26]

If the transfer is in lieu of foreclosure, and the creditor sells the home shortly thereafter, the taxpayer must determine the property's selling price. One of the IRS's FAQs suggests that taxpayers who don't agree with the information on a Form 1099-C, *Cancellation of Indebtedness,* should contact the creditor and have the creditor issue a corrected form.

Nonrecognition of Gain

Any taxable gain triggered on foreclosure of the taxpayer's principal residence is eligible for exclusion under IRC §121. This exclusion is $250,000 for a taxpayer filing as a single person, and $500,000 on a joint return.[27]

For the exclusion to apply, the taxpayer must satisfy the occupancy and use requirements of the statute. The taxpayer must own the home and use it as his principal residence for at least two out of the previous five years.[28] There are exceptions to the two-out-of-five-year rule if the sale of the residence is due to a change in the taxpayer's employment, health, or unforeseen circumstances.

Note. The 5-year period is extended under certain circumstances, such as active military duty.

The IRS, in its FAQ, did not say whether it would treat foreclosure of a residence as an unforeseen circumstance.

Observation. While the IRS has liberally interpreted unforeseen circumstances in recent years, a drop in the market value of a home would likely not meet the test and neither would readjustment of the interest rate of an adjustable rate mortgage.

As is the case with foreclosure of nonrecourse debt, if the holding period requirement is met and the residence was the taxpayer's principal residence, the foreclosure amount representing gain is tax-free up to $250,000 on a single return, or $500,000 on a joint return. However, the cancellation of debt is generally taxable as ordinary income.[29]

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23. For recourse debt, the amount realized generally cannot exceed the FMV of the property. Rev. Rul. 90-16, 1990-1 CB 12; Treas. Reg. §1.1001-2(c). This limitation applies even if the amount bid at the foreclosure sale exceeds the property's fair market value. *Frazier v. Comm'r,* 111 TC 243 (1998).

24. Treas. Reg. §1.61-12. That amount is reported to the taxpayer on Form 1099-C, Box 7.

25. *Community Bank v. Comm'r,* 819 F.2d 940 (9th Cir. 1987), *aff'g,* 79 TC 789 (1982); *Frazier v. Comm'r,* 111 TC 243 (1998); *Maracaccio v. Comm'r,* TC Memo 1995-174, (Apr. 17, 1995).

26. *Frazier v. Comm'r,* 111 TC 243 (1998)

27. IRC §§121(b)(1)-(2)

28. IRC §121(a)

29. IRC §61(a)(12)

Nonrecognition of CODI

In some instances, CODI is not taxable. Described below are instances when CODI is not taxable.

> **Note.** The amount of CODI that is not taxable is claimed on IRS Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*, by checking the box at Line 1(b) in Part I and indicating the amount of debt forgiveness exempt from federal income tax on Line 2. Form 982 must be attached to the taxpayer's Form 1040 for the year in which the debt is cancelled.

Insolvency

CODI is not taxable if the debtor is insolvent (both before and after the transfer of property and transfer of indebtedness) and is not in bankruptcy.[30] However, insolvent debtors must reduce tax attributes and reduce the income tax basis of property.[31] The amount of CODI that can be excluded from income is limited to the extent of the debtor's insolvency. If the amount of discharged debt exceeds the insolvency amount, income is triggered as to the excess.

Key Points on Insolvency

- The determination of the taxpayer's solvency is made immediately before the discharge of indebtedness.
- Insolvency is defined as the excess of liabilities over the FMV of the debtor's assets. Both tangible and intangible assets are included in the calculation. Accrued but unpaid interest creates insolvency, but does not create CODI for a cash-basis taxpayer.
- Both recourse and nonrecourse liabilities are included in the calculation, but contingent liabilities are not.
- Separate assets of the debtor's spouse are not included in determining the extent of the taxpayer's insolvency.
- Historically, the courts have held that property exempt from creditors under state law is not included in the insolvency calculation. However, the IRS ruled to the contrary,[32] and the Tax Court agreed in the *Carlson* case.[33]

  Because of the differences in state exemption statutes, the IRS position treats all debtors equally regardless of location. In addition, the IRS position prevents taxpayers who are truly solvent from avoiding tax. For example, in *Quartemont,*[34] the taxpayers tried to exclude their home from the calculation of insolvency. The taxpayers made an unsecured loan to an unrelated party who subsequently defaulted. They then built up substantial credit card debt and couldn't pay it back because of the unrelated party's default. The taxpayers had over $77,000 of credit card debt cancelled and claimed the amount wasn't taxable because they were insolvent. At the time, the taxpayers had almost $150,000 of equity in their home. The court, following *Carlson,* ruled that the value of the home (an exempt asset) had to be taken into account for purposes of insolvency. As such, the taxpayers were not insolvent.
- The amount of excluded CODI is limited to the extent of the debtor's insolvency. Therefore, if the amount of CODI exceeds the amount of insolvency, the taxpayer is made solvent and the CODI may have to be recognized (unless it can be excluded under a different exclusionary rule).
- The amount of CODI excluded must be used to reduce the taxpayer's tax attributes.

> **Note.** The attribute reductions are made **after** the determination of the tax imposed for the taxable year of the discharge.

30. IRC §108(a)(1)(B)
31. IRC §108(b)
32. Ltr. Rul. 199932013 (May 4, 1999), *revoking*, Ltr. Rul. 9125010 (Mar. 19, 1991); Tech. Adv. Memo. 199935002 (May 3, 1999)
33. *Carlson v. Comm'r*, 116 TC No. 9 (2001)
34. *Quartemont v. Comm'r*, TC Summ. Op. 2007-19 (Feb. 6, 2007)

Example 3. Jerri is insolvent both before and after the discharge. She has $200,000 of debts discharged in 2008. She also has $100,000 of taxable income from the liquidation of property in 2008. Her 2007 return shows a carryforward NOL of $150,000 and a carryover tax credit of $20,000.

Jerri first uses her NOL and tax credit attributes to reduce income and income tax for 2008. Any unused attributes are then reduced by the amount of the discharged debt.

Schedule C income	$100,000
CODI	200,000
	$300,000
NOL	$150,000
Tax credit	20,000
Schedule C income	$100,000
NOL	(150,000)
Excess NOL	$ 50,000
CODI	$200,000
Remaining NOL	(50,000)
New CODI	$150,000
Tax credit ($20,000 × 3)	(60,000)
Remaining CODI	$ 90,000

Order of Attribute Reduction

1. Any **NOL** for the taxable year of discharge, and any NOL carryover to the taxable year of discharge
2. Any **carryover credits** to or from the taxable year of the discharge of an amount allowable under IRC §§38, 40, 44B, and 44E
3. Any **minimum tax credit** available under IRC §53(b) as of the beginning of the tax year immediately following the taxable year of discharge
4. Any **net capital loss** for the taxable year of the discharge, and any capital loss carryover to the taxable year of discharge (current year used first)
5. **Basis reduction** to the taxpayer's property that conforms to IRC §1017
   - a. No reduction is made to the debtor's exempt property.
   - b. Basis reduction is not treated as a disposition for investment credit recapture purposes.
   - c. The amount of basis reduction is limited to the excess of the aggregate of the bases of the property held by the taxpayer immediately after the discharge less the aggregate of liabilities of the taxpayer immediately after the discharge.
   - d. Basis reduction applies to any property the taxpayer holds as of the beginning of the tax year following the year of discharge.
   - e. Basis reduction is treated as a depreciation deduction. Therefore, on later sale of the property at a gain, IRC §1245 recapture (ordinary income treatment) applies even though the property that has a basis reduction is not IRC §§1245 or 1250 property.
   - f. Treas. Reg. §1.1017-1 sets forth the sequence of basis reduction.
6. Any **passive activity loss or credit carryover** of the taxpayer under IRC §469 from the taxable year of discharge
7. Any **foreign tax credit carryover** to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under IRC §33

Amount of Attribute Reduction

- Generally, attributes are reduced one dollar for each dollar of CODI excluded from income.
- Credit carryovers are reduced $.3333 for each dollar of CODI excluded from income.[35]

Special Rule — Election to Reduce Basis First

An insolvent taxpayer may elect to use all or a portion of the excluded CODI to first reduce basis in depreciable property.

Note. The election may allow the taxpayer to preserve NOLs and tax credit carryovers.

- Depreciable property is defined in IRC §1017(e) and, by election, may include real estate held as inventory.
- The time of the election is specified in IRC §108(d)(8)(A) and the underlying regulations.
- The election is made at the beginning of the tax year after the tax year of debt cancellation and applies to all property held by the taxpayer at that time.

Note. The election to reduce basis first must generally be made on the tax return for the tax year of the debt cancellation. However, if reasonable cause is established for failure to file the election with the original tax return, the election may be filed with an amended return or on a claim for credit or refund. The election is made on IRS Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness and Section 1082 Basis Adjustment*. In addition, Treas. Reg. §§1.1017-1 and -2 and Rev. Proc. 85-44 provide guidance on the election.

- After the basis in depreciable property is reduced, the taxpayer's remaining tax attributes are reduced.

Partnerships. If partnership debt is cancelled (due to bankruptcy or insolvency), the rules for exclusion of CODI from gross income and for tax attribute reduction are applied at the individual partner level. Each partner's share of CODI must be reported on the partner's return unless the partner meets the bankruptcy or insolvency exclusions. For purposes of reducing basis in depreciable property, a partner treats his partnership interest as depreciable property to the extent of the partner's proportionate interest in the partnership's depreciable property. However, the partnership must make a corresponding reduction in the partnership's basis in its depreciable property with respect to the partner.

The allocation of an amount of CODI to a partner results in that partner's basis in the partnership being increased by that amount. Simultaneously, the reduction in the partner's share of partnership liabilities caused by the debt cancellation results in a deemed distribution. This in turn results in a reduction of the partner's basis in the partnership. These basis adjustments are separate from any basis reduction under the attribute reduction rules.

Bankruptcy

A debtor in bankruptcy does not need to report CODI.[36] However, he must reduce tax attributes and reduce income tax basis.

- The amount of CODI that would otherwise be taxable must be used to reduce tax attributes.
- For individual bankruptcy filers, the required reduction of tax attributes must be made to the attributes acquired from the debtor taxpayer by the bankruptcy estate.
- The order of the reduction and the basis adjustment election are the same as under the insolvency rules.
- Chapters 12 and 13 do not create a separate taxable entity as does a filing under Chapter 7 or 11. Thus, the debtor, not the bankruptcy estate, reduces tax attributes.

35. IRC §108(b)(3)(B)

36. IRC §108(a)(1)(A)

Purchase Price Adjustment

When the seller of specific property reduces a debt that arose out of the property's purchase, the reduction to the purchaser of the purchase-money debt is treated, for both buyer and seller, as an adjustment to the purchase price. In this situation, the purchaser does not recognize any debt discharge income.[37]

Note. The purchase price reduction rule is not elective. A solvent debtor to which the provision applies may not choose to recognize CODI as a result of the purchase price reduction.

The rule applies only if the reduction to the purchaser does not occur in a bankruptcy case or when the purchaser is insolvent, and only if the amount of the reduction would otherwise be treated as CODI but for this rule.

Other Exceptions

While the exceptions do not apply in the context of mortgage foreclosure settings, there are two additional exceptions from the general rule that CODI produces ordinary income.

- **Real Property Business Debt.** Taxpayers other than C corporations can elect to exclude from gross income the amount realized from the discharge of qualified real property business indebtedness. Rather than excluding the discharge amount, the income tax basis of the property is reduced. The provision does not apply to farm indebtedness.
- **Solvent Farmers.** For all debtors other than farmers, once solvency is reached and there is CODI, then the CODI must be recognized. For **solvent farm debtors,** the discharge of qualified farm indebtedness arising from an agreement between a person engaged in the trade or business of farming and a qualified person is eligible for special treatment. A special procedure for reducing tax attributes and reducing the basis of property is available to the debtor.
  - A qualified person is someone who is actively and regularly engaged in the business of lending money and who is not related to or connected with the debtor.
  - Qualified farm indebtedness means indebtedness incurred directly in connection with the operation of the trade or business of farming and 50% or more of the taxpayer's average annual gross receipts for the three proceeding taxable years (in the aggregate) must be attributable to the trade or business of farming.

Observation. In many instances, the presence of income earned off the farm can make qualifying for the solvent farm debtor rule difficult.

Deductible Items

Any portion of a cancelled debt, including interest, which would have been deductible if paid is not subject to federal income tax. Consequently, the portion of cancelled debt that is attributable to accumulated deductible mortgage interest is not taxable.

SHORT-SALE TRANSACTIONS

A short sale occurs when a homeowner sells the home for less than the existing mortgage balance. The seller then tries to convince the lender to forgive the unpaid balance. For example, the seller receives no sale proceeds and all proceeds of the sale go to the lender, who then forgives the balance of the debt.

37. IRS Pub. 17, *Your Federal Income Tax (for Individuals)*

> **Note.** The short-sale technique arose out of the current mortgage foreclosure climate and is a new use of the term. It does not refer to the Code's definition of the term. Under the Code, a short sale involves the sale of a borrowed item to be replaced at a future date and is usually a security. The IRS has never applied the term short sale to a real estate sale transaction.

When to Utilize — Bankruptcy's Impact on Credit Score

Typically, a debtor considers the use of a short sale in lieu of foreclosure in an attempt to protect his credit history. A bankruptcy is reported to credit bureaus and may remain on a credit report for up to 10 years after filing the bankruptcy petition. A potential lender that sees a bankruptcy on a consumer's credit report will likely view it as an extremely negative item, one that is worse than delinquencies or accounts in collections. It has a negative effect on an individual's credit score since a credit score is created from credit report information. Bankruptcy could potentially lower the credit score more than 100 points for an individual with otherwise good credit.

Bankruptcy makes it more difficult for the debtor to obtain credit, buy a home, and get insurance. Credit may only be obtainable from lower quality lenders and may carry very high interest rates.

The damage to the debtor's credit rating is less with a short sale. If the lender takes a loss on a mortgage, that information is reported to the credit bureaus. Whether the report states "settled for less than amount owed" or "foreclosure," the debtor's credit is marred. Although not as bad as a bankruptcy, this blemish remains on the debtor's credit report for seven years.

> **Observation.** There are certain debts that generally are not dischargeable in bankruptcy, such as taxes, student loans, child support, and alimony. Therefore, it is important for debtors to continue to make these payments on time. Any late payments could continue to be reported to credit bureaus and negatively impact the debtor's credit report information.

Tax Treatment

A short sale is taxed under the same rules as foreclosures.[38] If the underlying debt is recourse, the cancelled debt is not satisfied with the surrender of the property. Thus, any debt not satisfied with the sale proceeds is taxable as CODI.[39] For example, the amount realized on the sale of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness. Therefore, the transaction is bifurcated into a taxable sale of property and a taxable discharge of indebtedness. Each part is treated as a separate transaction for tax purposes.

The lender typically sends the seller an IRS Form 1099-C, *Cancellation of Debt*, noting the amount of the mortgage debt cancelled. That means that the tax consequences are the same as a mortgage foreclosure involving a recourse debt. In addition, it is questionable whether the lender would consent to the transaction and, in fact, forgive the debt.

> **Observation.** Perhaps the biggest benefit of a short sale is that the debtor can control the amount of the loss on the property and thereby limit the amount reported on Form 1099-C. If the debtor simply walks away from the property, the lender must take time to resell the property. In a declining market, that could mean a much larger loss on the property. Consequently, a short sale may help both the debtor and the lender.

38. *Stevens v. Comm'r*, TC Summ. Op. 2008-61 (June 3, 2008)

39. Rev. Rul. 92-99, 1992-2 CB 35. See also, Treas. Reg. §1.1001-2(a)(2).

If the short sale involves nonrecourse debt and the seller and the buyer require cancellation of the debt by the lender as a condition of the sale, the debt cancellation is included in the sale proceeds, the same as it would for a foreclosure.[40] The amount realized includes the full amount of the remaining debt.

Observation. A short sale can be a viable alternative to foreclosure for debtors with nonrecourse debt and who qualify for the sale of a principal residence exclusion.

DROP IN VALUE OF HOME — DEDUCTIBILITY AND TIMING OF A LOSS

In the present real estate market, it is entirely possible that the FMV of a home may drop below its purchase price if the purchase occurred relatively recently. If foreclosure or a short-sale transaction occurs and the underlying debt is nonrecourse, the difference between the mortgage balance at the time of foreclosure and the taxpayer's basis in the home is a nondeductible personal loss if the residence is the taxpayer's principal residence. The FMV of the property is disregarded for a nonrecourse mortgage. The loss incurred is deductible only if the mortgage indebtedness was incurred in connection with property either held for investment or used in the debtor's trade or business. But, if the foreclosure proceeds are used to pay outstanding interest or property tax obligations, they are typically deductible.[41] If the debt is recourse and a foreclosure or short sale occurs, CODI results on the difference between the home's FMV and the existing mortgage balance. A nondeductible personal loss (if the home is the taxpayer's personal residence) is triggered as to the difference between the taxpayer's basis in the home and the home's FMV.

Example 4. Scott and Helga purchased their California principal residence in 2006 for $500,000. On February 5, 2008, the lender foreclosed on the home. At that time, the FMV was $425,000 and the debt was $475,000. The loan was a nonrecourse loan. Scott and Helga have a $25,000 loss, and it is a nondeductible personal loss.

Loan balance at time of foreclosure	$475,000
Basis in principal residence	(500,000)
Loss incurred	($ 25,000)

Example 5. Use the same facts as **Example 4,** except their principal residence is in Illinois, the loan is a recourse loan, and the lender agrees to cancel the remaining debt. Scott and Helga realize CODI of $50,000 and a nondeductible personal loss of $75,000.

Loan balance at time of foreclosure	$475,000
FMV of principal residence	(425,000)
Cancellation of debt income	$ 50,000
Basis in principal residence	$500,000
FMV of principal residence	(425,000)
Nondeductible personal loss	$ 75,000

Regardless of whether the debtor is an accrual-basis or cash-basis taxpayer, any loss resulting from foreclosure is treated as occurring when the foreclosure (or transfer in lieu of foreclosure) takes place.[42] However, if the foreclosure matter is in litigation, the year in which the litigation terminates is the year in which tax items are taken into account.[43] The IRS took the position that if the debtor has a statutory right to reacquire the property following foreclosure (i.e.,

40. *2925 Briarpark Ltd. v. Comm'r,* 163 F.3d 313 (5th Cir. 1999), *aff'g,* TC Memo 1997-298 (June 30, 1997)

41. *Malmstedt v. Comm'r,* 578 F.2d 520 (4th Cir. 1978)

42. *Lamm v. Comm'r,* 873 F.2d 194 (8th Cir. 1989). That is also the case if the debtor has a right of redemption under state law. *Securities Mortgage Co. v. Comm'r,* 58 TC 667 (1972); *William C Heinemann & Co. v. Comm'r,* 40 B.T.A. 1090 (1939) CB 36.

43. *Great Plains Gasification Associates, et al. v. Comm'r,* TC Memo 2006-276 (Dec. 27, 2006)

redemption), the debtor's ability to deduct a loss is postponed until the right of redemption expires.[44] If the debtor exercises the right to redeem and then recovers possession of the property, no gain or loss is realized.[45] If state law provides for redemption rights, the debtor may avoid postponement of any foreclosure gain or loss by quitclaiming the redemption rights.[46]

If the foreclosed property's FMV is less than the outstanding mortgage and the lender releases the debtor from his obligation to pay the deficiency, any CODI which the debtor realizes is reported in the year the lender provides the release.

TAX CONSEQUENCES TO THE LENDER

In general, a lender may face two possible tax impacts when property is foreclosed.

1. Assuming the mortgage is a bad debt, the lender may have a bad debt deduction in the year of foreclosure on the outstanding portion of the mortgage.[47] Therefore, the lender can take a partial bad debt deduction if the mortgage is partially worthless and the lender charges off the worthless portion.[48]

2. The lender may recognize gain or loss on the final disposition of the property.

To the extent that amounts received from a foreclosure sale of mortgaged property to a third party exceed the lender's total claim, (including all costs associated with the foreclosure), the excess is normally paid to the debtor. It is unusual for a lender to realize a gain from a foreclosure sale.[49] However, the lender could experience gain if the lender originally purchased the mortgage debt at a discount, or had previously taken a partial bad debt deduction which reduced the lender's basis in the loan.

Nonrecourse Debt

In the case of a nonrecourse mortgage in which the lender purchases the mortgaged property in a foreclosure sale, the lender has a taxable gain or loss to the extent of the difference between the bid price and the lender's basis in the mortgage.

The bid price usually is presumed to be the property's FMV. However, the presumption does not apply when the lender is the seller and is also the party foreclosing on the property. When the seller or lender repossesses property in satisfaction of the indebtedness, no loss is recognized and, under certain circumstances, gain may be recognized.[50] The result is the same with a recourse mortgage if the bid price equals or exceeds the outstanding debt. The lender's basis is determined by subtracting principal paid from the loan's face amount.

Example 6. Holly's Home Mortgages, Inc. is in the business of making residential real estate loans. Believing that housing prices would continue to rapidly escalate, the company made a nonrecourse home loan for $600,000. Due to the borrower's failure to make payments on the loan, the company foreclosed on the property. The unpaid balance of the loan was $575,000 at the time of the sale. At the foreclosure sale, the company purchased the property for $525,000. The company has a deductible loss of $50,000. They also have a basis of $525,000 in the property for purposes of a later sale.

Example 7. Use the same facts as **Example 6,** except the company repossess the home rather than causing a foreclosure sale. The company cannot recognize the loss. The basis in the property is the unpaid balance of the loan at the time of repossession, or $575,000.

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44. Rev. Rul. 70-63, 1970-1 CB 36

45. *Hotz v. Comm'r,* 42 B.T.A. 432 (1940)

46. *Atmore Realty Co. v. Comm'r,* B.T.A. Memo 1942-248 (1948)

47. IRC §166(a). *Comm'r. v. Spreckels,* 120 F.2d 517 (9th Cir. 1941). If the mortgage is a nonbusiness bad debt, subject to IRC §166(d), the loss is a short-term capital loss.

48. IRC §166(a)(2) and Treas. Reg. §1.166-3

49. A loss may be recognized for tax purposes in the year of foreclosure, even though the mortgagor has a right of redemption. See *Securities Mortgage Co. v. Comm'r,* 58 TC 667 (1972); *William C Heinemann & Co. v. Comm'r,* 40 B.T.A. 1090 (1939).

50. IRC §1038

Recourse Debt

If the lender purchases mortgaged property in a foreclosure sale and the mortgage is recourse, the lender has the right to try to recover the deficiency from the debtor. Since recovery on a deficiency judgment would make the lender whole, any loss that the lender might have can only be taken in the foreclosure year. This is provided the company can show that the deficiency is uncollectible in that year.[51] Otherwise, the lender subtracts the foreclosure recovery from its original debt basis to determine its basis in the deficiency. The lender then defers reporting gain or loss until the collectability (or uncollectability) of the deficiency is determined.[52] Accrued interest may be included as part of the deduction allowable related to a mortgage foreclosure, but only if the interest was reported as income.[53]

HANDLING EXPENSES OF FORECLOSURES AND REPOSSESSIONS

Court costs, legal fees, and other foreclosure costs related to property sold at foreclosure reduce the proceeds that the lender receives. Any expenses and liens the lender pays to protect the mortgaged property before the foreclosure sale is added either to the lender's basis for the loan or to its basis for the acquired property, depending upon when they are paid. Amounts paid **before** a foreclosure are added to the lender's loan basis. Expenses paid **during** the foreclosure proceedings are added to the lender's property basis or to the deficiency judgment if the lender does not acquire the property.[54]

A foreclosure by a prior lienholder generally eliminates a lender as a secured creditor, but any resulting loss is not deductible by the lender until the junior note (previously secured by the foreclosed property) is proven worthless.[55]

Note. Seller financing is treated as a repossession of real property.[56]

ALTERNATIVES TO FORECLOSURE

In any given situation, there may be alternatives to foreclosure. Depending on the circumstances, these can be used to improve the tax consequence.

Restructuring the Debt

Restructuring the debt may be mutually beneficial for the parties. A substitution of a new debt instrument in satisfaction of outstanding indebtedness is treated as satisfaction of the outstanding indebtedness with an amount of money equal to the issue price of the new debt instrument.[57] That may trigger CODI for the debtor equal to the difference between the new debt instrument's issue price and the adjusted issue price of the old debt instrument. Alternatively, if the debt is actually cancelled, the debtor may realize ordinary income to the extent of the discharge.

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51. Treas. Reg. §§1.166-6(a) and 1.165-5(e); *Estate of Jewett v. Comm'r,* TC Memo 1949-163 (1949); *Havemeyer v. Comm'r,* 45 B.T.A. 329 (1941), *acq* 1942-1 CB 8

52. Treas. Reg. §1.166-6(a)(1)

53. Treas. Reg. §1.166-6(a)(2); *Federal Home Loan Mortgage Corporation v. Comm'r,* 121 TC 279 (2003) (in computing gain or loss from a mortgage foreclosure, taxpayer cannot increase adjusted cost basis in the mortgage by interest that accrued while taxpayer was tax-exempt).

54. *Heger v. Comm'r,* TC Memo 1993-408, *aff'd*, 35 F.3d 561 (5th Cir. 1994), payments made to avoid foreclosure were **not** allowed to be added to basis.

55. *Berenson v Comm'r,* 39 B.T.A. 77 (1939), *aff'd* 113 F.2d 113 (2nd Cir. 1940)

56. IRC §1038

57. IRC §108(e)(10)

Modifications of the Indebtedness

Other restructuring alternatives may involve an extension of the mortgage term, waiver of current debt service payments, and addition of unpaid interest to the principal balance of the mortgage. If the modification is not material, these types of adjustments have historically been treated as nonrecognition events.[58] However, the U.S. Supreme Court created a rather low threshold in determining whether a modification of terms is material enough to be treated as a deemed exchange of old debt for new debt with resulting tax consequences.[59] Likewise, the regulations specify that there is a realization event if the debt instrument modification is significant.[60] For this purpose, a modification is ''any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.''[61] Most temporary forbearances of a debtor's failure to perform are not considered significant modifications. Therefore, they do not result in a realization event providing that a forbearance of under two years (and sometimes longer) is temporary for these purposes.[62]

The restructuring of an existing loan by entering into a loan modification agreement may cause the lender to be treated as having disposed of the original mortgage, and the borrower may have CODI if the principal amount of the old loan exceeds the principal amount of the new one. The modification may also trigger the original issue discount rules that treat a portion of the new debt principal as imputed interest. If the principal of the old debt is greater than the imputed principal of the new debt, a solvent borrower generally realizes CODI.[63]

Installment Sale

Installment sale reporting may be used to defer recognition of a part of the gain until the installment payments are collected in the future. The major limitation in this strategy is that any excess of the mortgage balance less the adjusted basis of the property is treated as payment received in the year of sale.

Like-Kind Exchanges

Like-kind exchanges may be used as an alternative to foreclosure.[64] However, it may be difficult to find property suitable for exchange. Usually, the debtor's property has a relatively high outstanding mortgage balance, with a low equity value. In this situation, the debtor must make up the difference in cash in the trade and trade up to a higher-value property. That may not be possible.

CONSTRUCTIVE RECEIPT ISSUES IN DEBT RESTRUCTURINGS

Constructive receipt of income may occur when a mortgage is extended or restructured. Constructive receipt of income occurs when the taxpayer has an unrestricted right to receive the income, is able to collect it, and the result of the failure to do so was the choice of the taxpayer.[65] If the debtor is unable to pay a mortgage note when due, the lender has not constructively received income. If, however, a note is extended or restructured as an accommodation to a debtor who is otherwise able to pay, constructive receipt of the entire principal due may occur on the note's due date.

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58. Rev. Rul. 73-160, 1973-1 CB 365 (extension of maturity date of notes not a taxable transaction); *Soter v. Comm'r,* TC Memo 1968-43, (Mar. 14, 1968), Rev. Rul. 68-419, 1968-2 CB 196 (modification of purchaser's note to defer principal payment dates and increase interest rate not disposition or satisfaction of an installment obligation); Rev. Rul. 55-429, 1955-2 CB 252.

59. *Cottage Savings Assoc. v. Comm'r,* 499 U.S. 554 (1991), *rev'g and rem'g,* 890 F.2d 848 (6th Cir. 1989)

60. Treas. Reg. §1.1001-3

61. Treas. Reg. §1.1001-3(c)(1)

62. Treas. Reg. §1.1001-3(c)(4)(ii)

63. IRC §108(e)(11)

64. IRC §1031

65. Treas. Reg. §1.451-2(a); *Saint Claire Corp. v. Comm'r,* TC Memo 1997-171, (Apr. 07, 1997)

To avoid constructive receipt, any extension or superseding agreement must be agreed to before the existing mortgage note or loan becomes due.[66]

Observation. Constructive receipt issues may be more likely to occur when real property is sold to related parties, to controlled entities, or to parties who are well-known to the seller.

NEW LEGISLATION

Mortgage Forgiveness Debt Relief Act of 2007

Under prior law, forgiven debt by a lender on a principal residence mortgage was generally considered taxable income. Exceptions to this general rule applied for taxpayers who were bankrupt under Title 11 or insolvent.

In late 2007, Congress created another exception to the general rule that CODI produces ordinary income.[67] This exception is available for discharges occurring after 2006 and before 2010. It provides that up to $2 million for taxpayers filing as MFJ in acquisition indebtedness[68] that is forgiven on a mortgage attributable to the taxpayer's principal residence is excludable from gross income.[69] This exception is not available for a second home, credit card, or car loan debt. The mortgage proceeds must be used by the taxpayer to acquire, construct, or make substantial improvements to the principal residence.

The amount of forgiven debt must be reported on IRS Form 982 and attached to the taxpayer's return. The lender should send the taxpayer a Form 1099-C by January 31 of the year following the year of the cancellation. The amount of cancelled debt is shown in Box 2. If the debt is all qualified principal residence indebtedness, the amount in Box 2 generally is the amount that is entered on lines 2 and 10b of Form 982.

The debtor's basis in the residence must be reduced (but not below zero) by the amount excluded from income. The exclusion does not apply to debtors in bankruptcy. It does apply to insolvent debtors, unless the debtor elects to apply the exclusion for insolvent debtors. The exclusion does not apply to the discharge of a loan if the discharge is due to services performed for the lender.

Qualified Principal Residence Indebtedness. The new legislation applies to forgiven or cancelled debt that is used to buy, build, or substantially improve the taxpayer's principal residence, or to refinance debt incurred for those purposes. The debt must be secured by the principal residence. As for refinancing, debt used to refinance a home qualifies for the exclusion, but only up to the extent that the principal balance of the old mortgage, immediately before the refinancing, would have qualified.

Note. In a debt consolidation refinancing, if a client takes out cash or has consolidated a home equity line of credit for purposes other than to acquire a house, then that part of the debt is home equity debt. This type of debt does not qualify for the $2 million exclusion. However, such debt may qualify for exclusion from income under the insolvency or bankruptcy exceptions.

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66. *Martin v. Comm'r,* 96 TC 814 (1991); *Oates v. Comm'r,* 18 TC 570 (1952), *aff'd*, 207 F.2d 711 (7th Cir 1953); *Saint Claire Corp. v. Comm'r,* TC Memo 1997-171, (Apr. 07, 1997) (constructive receipt of entire remaining principal occurred when mortgage note was extended on the date it became due and obligor was otherwise able to pay).

67. H.R. 3648, the Mortgage Forgiveness Debt Relief Act of 2007, enacted into law on December 20, 2007.

68. "Acquisition indebtedness" is defined in accordance with IRC §163(h)(3)(B).

69. H.R. 3648, Sec. 2(b), *amending* IRC §108 by adding new subsection (h).

Qualified principal residence indebtedness is the debt that is **not** more than the cost of the principal residence plus improvements. Any debt, secured by the principal residence that is used to refinance qualified principal residence indebtedness is treated as qualified principal residence indebtedness, but only up to the amount of the old mortgage principal prior to the refinancing. Any additional debt that is used to substantially improve the principal residence is also treated as qualified principal residence indebtedness. To qualify as a principal residence, the property must be owned and occupied by the taxpayer as her principal residence for two of the last five years. Refinancing the qualified personal residence indebtedness is also considered acquisition debt, but only to the extent of the debt being refinanced.[70]

Example 8. Tim and Sherry bought their principal residence in 2003 for $300,000. It was financed, in part, by a $280,000 mortgage. The lender foreclosed on their home in January 2008, when the outstanding principal balance was $260,000. The lender sold the home in 2008 for a net price of $250,000 and forgave Tim and Sherry the unpaid mortgage balance of $10,000. Under the new law, the $10,000 is excluded from their 2008 gross income.

Purchase price in 2003 (basis)	$300,000
Original mortgage amount	280,000
Mortgage balance at time of foreclosure	260,000
FMV when lender sold home	250,000
Mortgage balance	$260,000
Sale by lender	(250,000)
CODI for Tim and Sherry	$ 10,000

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, and ZIP code Last Bank of America			OMB No. 1545-1424 2008 Form 1099-C	Cancellation of Debt
CREDITOR'S federal identification number 10-3456789	DEBTOR'S identification number 888-77-9999	1 Date canceled 01/20/08	2 Amount of debt canceled $ 10000.00	Copy B For Debtor
DEBTOR'S name Tim and Sherry		3 Interest if included in box 2 $	4	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.) City, state, and ZIP code		5 Debt description Residence Mortgage		
Account number (see instructions)		6 Bankruptcy (if checked) ☐	7 Fair market value of property $ 250000.00	

Form 1099-C (keep for your records) Department of the Treasury - Internal Revenue Service

70. IRC §163(h)(3)(B)

For Example 8

Form **982** (Rev. February 2008) Department of the Treasury Internal Revenue Service

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

► Attach this form to your income tax return.

OMB No. 1545-0046

Attachment Sequence No. **94**

Name shown on return	Identifying number
Tim and Sherry	888-77-9999

Part I **General Information** (see instructions)

1	Amount excluded is due to (check applicable box(es)):		
a	Discharge of indebtedness in a title 11 case		☐
b	Discharge of indebtedness to the extent insolvent (not in a title 11 case)		☐
c	Discharge of qualified farm indebtedness		☐
d	Discharge of qualified real property business indebtedness		☐
e	Discharge of qualified principal residence indebtedness		☒
2	Total amount of discharged indebtedness excluded from gross income	**2**	10,000
3	Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?		☐ Yes ☐ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

	Enter amount excluded from gross income:		
4	For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	**4**	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	**5**	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	**6**	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	**7**	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	**8**	
9	Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge	**9**	
10a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness.*	**10a**	
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked*	**10b**	10,000
11	For a discharge of qualified farm indebtedness, applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5	**11a**	
b	Land used or held for use in a trade or business of farming	**11b**	
c	Other property used or held for use in a trade or business, or for the production of income	**11c**	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	**12**	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	**13**	

Part III **Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)**

Under section 1081(b), the corporation named above has excluded $ .... from its gross income for the tax year beginning .... , and ending .... Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of ....
(State of incorporation)

Note. *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

For Paperwork Reduction Act Notice, see page 4 of this form. Cat. No. 17066E Form **982** (Rev. 2-2008)

Ordering Rule

If only part of a loan is qualified principal residence indebtedness, the exclusion applies only to the extent the discharged amount exceeds the amount of the loan immediately before the discharge that is not qualified principal residence indebtedness.

Example 9. Jack and Mimmie's principal residence is secured by a debt of $500,000. Of this amount, $400,000 is considered qualified principal residence indebtedness. The residence sold for $350,000 and $150,000 of debt is discharged. Therefore, only $50,000 of the debt may be excluded ($150,000 discharged debt – $100,000 nonqualified debt).

Debt at time of foreclosure	$500,000	$500,000
Sale price		(350,000)
Debt forgiven		$150,000
Qualified principal indebtedness	(400,000)	
Nonqualified debt	$100,000	(100,000)
Excludable debt		$ 50,000

The exclusion from gross income does not apply to debt forgiven in a Chapter 11 bankruptcy case. If debt is forgiven other than in a foreclosure, the taxpayer must reduce the basis in the principal residence by the amount of the excluded debt. The forgiven debt is only excluded from gross income if the discharge is due to a decline in the value of the residence or in the financial condition of the taxpayer.

Note. The Housing Assistance Tax Act of 2008 also contains provisions which attempt to aid the distressed housing industry. The provisions are discussed in Chapter 11, "New Legislation." Also see Chapter 15, "Rulings and Cases," in the Bankruptcy and Discharge of Indebtedness section for more information on Form 982

ISSUE 3: DEDUCTIBILITY OF THEFT LOSSES AND/OR LOSSES ON WORTHLESS SECURITIES

The problems associated with the subprime lending abuses have given rise to numerous issues. One of these issues involves the deductibility of losses by taxpayers who loaned money to a subprime lending company. Two types of losses could be involved theft losses and losses on worthless securities.

Theft Losses

Theft losses are only deductible in the year of discovery rather than the year that the theft occurred. The deduction amount is tied to the item's FMV immediately preceding the theft, limited by the taxpayer's basis in the item.

Losses on Worthless Securities

A loss on a worthless security is deductible even if the taxpayer did not sell the security. It is only deductible in the year of total worthlessness. It is important to determine what constitutes worthlessness. An investment in a company that has gone bankrupt is not enough. The IRS says that if there is any chance the investment can be recovered, it is not wholly worthless. One of the following could substantiate "worthless:"

- A broker's note saying a stock ceased trading during the year
- A news article about the firm liquidating and evidence that it owes more to creditors and bondholders than the total of its assets

It's important to support the fact that there are no funds left for investors. The IRS has taken the position that an investment is totally worthless if the taxpayer's stock is still trading, but would bring less than the broker's commission for selling it.

> **Note.** To write off a worthless stock, a taxpayer reports it on Schedule D as if it was sold for nothing at the end of the year. That date also determines whether the taxpayer has a short-term or long-term loss. On Schedule D, where the taxpayer is asked for the sale date and selling price, "worthless" is entered. The loss is the full cost of the investment.

Overlapping Areas

There is potential overlap between theft losses and losses for worthless securities given the current subprime problems. The IRS issued guidance concerning the potential overlap.[71] Under the facts as presented to the IRS, the taxpayers were lenders who loaned money to an established company that wrote subprime mortgage loans. The company had been a legitimate business. As its subprime losses mounted, it provided false and fraudulent information to its investors to encourage them to continue to lend money to the company. Eventually, several company insiders were convicted of or pled guilty to securities laws' violations based on their misrepresentations to investors. The investors did not get repaid. The guidance request concerned the issue of whether the taxpayers' losses were theft losses or losses on worthless securities.

The IRS reasoned that the losses qualified as theft losses because they resulted from a taking of property that was illegal under state law and which was done with criminal intent. The IRS compared the situation to a 1971 revenue ruling in which a corporation provided fraudulent financial statements to obtain a loan, and the corporate president was convicted of violating state securities laws in issuing the statements.[72] The ruling allowed the lender to take a theft loss deduction for the loan amounts that were not repaid. The key point is that a theft accomplished through a purported borrowing or offer to sell a security does not get converted to a worthless security loss but can qualify as a theft loss.

> **Observation.** The facts of a particular situation determine the outcome. At some point, loans to the lender no longer represent bona fide debt. Therefore, it is a question of fact when a loan to a lender is no longer bona fide debt and becomes a theft. It is also a question of fact when an officer's conduct concerning money entrusted to the lender by the investors becomes an appropriation of those funds with the intent to deprive investors of their property.

> **Note.** See the *Taghadoss* case in Chapter 15, "Rulings and Cases," regarding the deductibility of loss related to a significant drop in the value of securities.

ISSUE 4: FORGIVEN CREDIT CARD DEBT

While there are exceptions from the general rule of inclusion of cancelled debt in income, there is no exclusion available for forgiven credit card debt. A 2008 Tax Court case illustrates this point.[73]

In late 1992, Payne opened a credit card account with MBNA America Bank. He used the credit card to pay hospital bills and receive cash advances during times that he was unemployed. By early 2004, he had accumulated over $21,000 on the credit card. In late 2004, MBNA agreed to accept a little less than $5,000 as a full settlement of the account balance, to be paid in installments over four months. The petitioner made the payments and MBNA issued him a Form 1099-C to report the $16,678 of CODI. However, the petitioner did not report the CODI on his 2004 return. He wasn't insolvent or in bankruptcy, so he argued that the forgiven amount wasn't CODI. He argued it was a retroactive reduction of the interest rate that MBNA charged. In effect, it was a negotiated reduction in the "purchase price" of the loans under IRC §108(e)(5).

71. CCA Ltr. Rul. 200811016 (June 22, 2007)

72. Rev. Rul. 71-381, 1971-2 CB 126

73. *Payne v. Comm'r,* TC Memo 2008-66 (Mar. 18, 2008)

The court did not agree with Payne's theory. Lending money is not a sale of property for which the purchase price can be renegotiated; and the parties were not buyer and seller, but debtor and creditor. Consequently, IRC §108(e)(5) did not apply.

Observation. For tax years 2007–2009, taxpayers in the petitioner's situation who are buying a qualified residence should consolidate credit card debt with a home loan (i.e., "monetize" the home through borrowing). Any subsequent default on the loan would not result in taxable CODI. Acquisition indebtedness that is forgiven on a mortgage attributable to the taxpayer's principal residence (up to $2 million) is excludable from gross income for tax years 2007–2009.

ISSUE 5: S CORPORATION BANKRUPTCY

OVERVIEW

Many closely-held corporations file S elections for tax planning purposes. The major tax benefits of an S corporation as compared to a regularly-taxed C corporation include the following:

1. No corporate level tax; and
2. The C corporation does not receive the benefit of a lower tax rate on long-term capital gains that is available to individuals.

However, these benefits can become disadvantageous when the S corporation files bankruptcy. The shareholders do not receive income or other economic benefit from their ownership interest in the corporation. Taxable income still flows to the shareholders, even though income is not distributed. That results in tax liability to the shareholders.

Example 10. Grassy Wind, an S corporation, files bankruptcy. Grassy Wind owns a single asset. It is commercial rental property with an FMV of $2 million, a mortgage of $2 million, and an income tax basis of $1 million. The property sold for its FMV (or was foreclosed by the mortgage holder). There is a taxable gain of $1 million. This gain flows through to the shareholders, who are required to report it on their return and pay the resulting tax obligation.

As a result of the recognition of income, the adjusted basis of the shareholders' stock is increased by the $1 million gain. If the stock was worthless, the shareholders would be entitled to deduct the adjusted basis of the stock as a capital loss.

If Grassy Wind was a C corporation, then the tax would be an obligation of the bankruptcy estate.

Observation. It is often advantageous for the shareholder if the S corporation terminates its S status when the corporation enters into bankruptcy. This is true if the corporation will have post-petition income. Alternatively, it is advantageous for the bankruptcy estate to retain S status, because the shareholders are responsible for the taxes resulting from the S corporation's post-petition income. However, if the S corporation will have post-petition tax losses, it may be beneficial to the shareholders to retain the S election. This will allow the losses to pass through to the shareholders so they can be used to offset other income.

REVOKING THE S ELECTION

Bankruptcy Filing

Filing a bankruptcy petition by an S corporation does not, by itself, revoke the S election.

In *Mourad,*[74] an S corporation owned an apartment building and filed for Chapter 11 reorganization bankruptcy. During the course of the Chapter 11 case, the apartment building was sold. This triggered a taxable gain of over $2 million. The bankruptcy trustee filed an IRS Form 1120-S on behalf of the S corporation, showing the taxable gain. The trustee sent a Schedule K-1 to the sole shareholder, showing that all the income flowed through to him. The shareholder did not report the income on his tax return. The IRS assessed a deficiency, and the shareholder challenged the IRS's position in the U.S. Tax Court. The shareholder claimed that the bankruptcy filing terminated the S election. The termination resulted in the gain from the post-petition sale of the S corporation's apartment building not flowing through to him. However, the Tax Court held that the filing of a petition did not terminate the S election, or create a separate taxable entity. Consequently, the tax liability for the S corporation's post-petition income was not a liability of the bankruptcy estate, and the shareholder was liable for the payment of the resulting tax obligation.

Filing a Revocation

An S corporation may voluntarily terminate its S election by filing a revocation of the election with the IRS. Consent of more than 50% of the shareholders is required to terminate S status. To revoke the election, the IRS requires a statement from the:

- S corporation, and
- Shareholders that consent to the election.

The S corporation statement of revocation should include:

- Declaration that the corporation is revoking its S election
- Name, address, and TIN of the S corporation
- Number of outstanding shares of stock at the time of the revocation
- Date the revocation is to be effective
- Signature of officer authorized to sign Form 1120S

S corporation shareholders' statement should include:

- Name, address, and TIN of each shareholder consenting to the revocation
- Number of shares each consenting shareholder owns at the time of revocation
- Date(s) the S corporation stock was acquired
- Date the shareholders' tax year ends
- Name and TIN of the S corporation being terminated
- Shareholders' signatures with a statement indicating the document was signed under penalties of perjury

Waiting Period. There is a 5-year waiting period before the corporation can again elect S status, unless the IRS grants permission. Permission is rarely provided unless the corporation had a greater than 50% change in ownership.

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74. *Mourad v. Comm'r*, 121 TC 1 (2003), *aff'd*, 387 F.3d 27 (1st Cir. 2004)

Termination Date. If the termination date is not on the first day of the tax year, the S corporation must file two short-year returns. The first short year is for the S corporation (Form 1120S) and the second short year is for the corporation (Form 1120).

The decision to terminate the S election is irrevocable, but it can be set aside by a bankruptcy trustee. In *In re Bakersfield Westar, Inc.*,[75] the court reasoned that the S election created a right in the S corporation that is not subject to income taxation, and that such an election is a property right. As such, the revocation of the election is a transfer of the property right, which the bankruptcy trustee can set aside.

> **Observation.** The bankruptcy trustee may be motivated to set aside the revocation of an S election so that the assets of the bankruptcy estate are not diminished by the tax obligations resulting from the corporation's post-petition income.

Transfer of S Corporate Stock to Ineligible Shareholders

An alternative method of terminating the S corporation prior to filing bankruptcy is to transfer S corporate stock to nonqualified S corporation shareholders (e.g., a corporation). Such a transfer results in an automatic termination of the S election. If the shareholder making such a transfer is also in bankruptcy, it is difficult for the bankruptcy trustee to argue that such a transfer can be set aside, because it is the shareholder, not the S corporation that is not making the transfer of shares. That appears to be outside the scope of *In re Bakersfield Westar, Inc*. In that case, the court set aside the voluntary revocation of the S election by the S corporation — it was the voluntary action of the S corporation that the court treated as the transfer of a property right that could be avoided. However, in the case of transfer of shares by an S corporation shareholder, the S corporation has no control.

> **Note.** Courts have given bankruptcy trustees great latitude in setting aside actions which are considered irrevocable under the Code. It is possible that a court might develop a theory that would allow the trustee to set aside such a transfer of shares by the shareholder of an S corporation.

> **Observation.** Before utilizing a strategy to voluntarily revoke the S election, the S corporation shareholders should carefully review all corporate documentation, including the Articles of Incorporation, bylaws, and any shareholder agreements to ensure that the corporation has no rights to control the transfer of shares in the corporation. Many shareholder agreements, for example, routinely provide a right of first refusal to the corporation before shares can be transferred to a third party. In that situation, the trustee or creditors committee would most likely successfully argue that the transfer of shares in violation of the corporation's rights under the agreement can be set aside.

Other Considerations

Before taking steps to terminate an S election, consideration should be given to the tax cost that might arise if the S corporation emerges from bankruptcy. Once an S election is terminated, a new election cannot be made for another five years. This could lead to future double-taxation problems that may exceed the tax burden created by income of the S corporation flowing through to the shareholders during the bankruptcy. Clearly, a careful review of the benefits and disadvantages of terminating an S election should be undertaken before deciding on a course of action.

75. *In re Bakersfield Westar, Inc*, 226 B.R. 227 (B.A.P. 9th Cir. 1998)

ISSUE 6: REPORTING INCOME ON THE TAX RETURN

FORM 1099

Form 1099 is used to report a variety of unique income payments to the IRS. This form is typically used when the taxpayer receives income from sources other than a wage-paying job. Form 1099 is filed to help the IRS determine if it is receiving the correct amount of tax from the taxpayer.

Two types of 1099s pertain to debt and foreclosures:

- Form 1099-A, *Acquisition or Abandonment of Secured Property*
- Form 1099-C, *Cancellation of Debt*

> **Note.** Income reported on a Form 1099 does not reflect the withholding of any state or federal taxes. The recipient of Form 1099 is responsible for remitting the appropriate tax to the IRS.

FORM 1099-A

Filing Requirement

Filing Form 1099-A is required of any lender in the trade or business of lending money and who, in full or partial satisfaction of the indebtedness, acquires an interest in the debt-secured property or who has reason to know that the property was abandoned. A copy of Form 1099-A (or an acceptable substitute statement) must be furnished to the borrower by January 31 of the year following the year the lender acquired an interest in the property, or knows or has reason to know the property was abandoned. The lender must also file a copy with the IRS by February 28, or by April 1 if electronically filed. The lender must indicate the date on which the lender acquired an interest in the property, or the date the lender learned that the property was abandoned.

Example 11. Joe's No-Credit-Check Home Sales sells low-cost homes. Joe's normally finances sales to buyers with poor credit. When a buyer acquires a home and later abandons it, Joe's issues Form 1099-A.

Property is defined as any real property (including the borrower's principal residence), any intangible property, and tangible personal property (not including 100% personal use property, such as a car). Abandonment occurs when the objective facts and circumstances indicate that the borrower intended to and has permanently discarded the property from use.

Reporting the Income

> **Observation.** When a client brings a Form 1099-A to the tax practitioner, the practitioner should consult IRS Pub. 544, *Sales and Other Dispositions of Assets.* Each Form 1099-A is different and the tax reporting varies depending on the taxpayer's situation.

The abandonment of property is a disposition of property. As indicated above, abandonment occurs when the taxpayer voluntarily and permanently relinquishes possession and use of the property with the intention of ending ownership, but without transferring the property to anyone else. Loss from the abandonment of business or investment property is deductible as an ordinary loss, even if the property is a capital asset. The loss is the property's adjusted basis when abandoned. This rule also applies to leasehold improvements the lessor made for the lessee.

> **Note.** IRS Pub. 544, *Sales and other Dispositions of Assets*, explains how to determine gain or loss if the property is later subject to foreclosure or repossession.

An abandonment loss is deducted in the tax year in which the loss is sustained. A taxpayer cannot deduct any loss from abandonment of the taxpayer's home or other property that was held for personal use.

There are four basic tax filing outcomes:

1. If the lender acquires an interest in the property, such as through foreclosure, the borrower has a reportable gain or loss equal to the difference between the taxpayer's adjusted basis in the property and the amount realized. This is normally the amount of cancelled debt (box 2 of Form 1099-A) or the proceeds from the foreclosure sale, whichever is greater.
2. If the property was for personal use, the gain is reported on Schedule D, and a loss is normally not deductible.
3. If the property was business or income-producing property, the gain or loss is reported on Form 4797.
4. If the FMV of the property (Form 1099-A, box 4) is less than the outstanding debt (Form 1099-A, box 2) and the taxpayer is personally liable for the debt (Form 1099-A, box 5), the difference is the part of the gain on the foreclosure that the borrower must report as ordinary income.

Example 12. Derrick financed a timeshare in December 2000, for his personal use. His loan was for $8,900. On February 1, 2008, Derrick stopped paying his loan. He wrote to the timeshare company explaining that he could no longer afford to keep the timeshare and was abandoning it. The lender agreed not to pursue any deficiency against Derrick. Derrick receives a 2008 Form 1099-A for his abandonment of the timeshare. The principal at the time of abandonment was $7,500 and the FMV was $5,000.

Observation. Derrick has a nondeductible personal loss from the disposition of the timeshare interest.

☐ CORRECTED (if checked)

LENDER'S name, street address, city, state, ZIP code, and telephone no. First Fourth Bank of Anywhere 444 First Street Anywhere, IA 44444		OMB No. 1545-0877 2008 Form 1099-A	Acquisition or Abandonment of Secured Property
LENDER'S federal identification number 00-0000002 / BORROWER'S identification number 200-20-2000	1 Date of lender's acquisition or knowledge of abandonment 02/01/2008	2 Balance of principal outstanding $ 7500.00	Copy B For Borrower
BORROWER'S name Derrick	3	4 Fair market value of property $ 5000.00	This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.) 444 Fourth Avenue City, state, and ZIP code Anywhere, IA 44444	5 Was borrower personally liable for repayment of the debt? ☒ Yes ☐ No		
Account number (see instructions)	6 Description of property Timeshare		

Form 1099-A (keep for your records) Department of the Treasury - Internal Revenue Service

For Example 12

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2008 (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2008, or other tax year beginning , 2008, ending , 20 OMB No. 1545-0074

Label (See instructions on page 12.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial: Derrick	Last name		Your social security number: 200 20 2000
If a joint return, spouse's first name and initial	Last name		Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 12.: 444 Fourth Avenue		Apt. no.	You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 12.: Anywhere, IA 44444			Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 12) ▶ ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☒ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 13.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 14)

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 15)
			☐
			☐
			☐
			☐

If more than four dependents, see page 15.

d Total number of exemptions claimed

Boxes checked on 6a and 6b
No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 16)

Dependents on 6c not entered above
Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 19.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7	
8a	**Taxable** interest. Attach Schedule B if required		8a	
b	**Tax-exempt** interest. **Do not** include on line 8a	8b		
9a	Ordinary dividends. Attach Schedule B if required		9a	
b	Qualified dividends (see page 19)	9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 20)		10	
11	Alimony received		11	
12	Business income or (loss). Attach Schedule C or C-EZ		12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13	
14	Other gains or (losses). Attach Form 4797		14	
15a	IRA distributions	15a; b Taxable amount (see page 21)	15b	
16a	Pensions and annuities	16a; b Taxable amount (see page 22)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17	
18	Farm income or (loss). Attach Schedule F		18	
19	Unemployment compensation		19	
20a	Social security benefits	20a; b Taxable amount (see page 24)	20b	
21	Other income. List type and amount (see page 24)	Form 1099-A	21	2,500
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶			

FORM 1099-C

Filing Requirement

Beginning in 2005, every organization that has a significant portion of its trade or business dedicated to the lending of money must file a Form 1099-C, *Cancellation of Debt,* upon cancellation of indebtedness of $600 or more for a debtor.

The lender submits Form 1099-C to the IRS and to the person whose debt was cancelled or forgiven. The form reports the amount of the cancelled debt in box 2. For borrowers that gave up their home in a short sale, foreclosure, or other settlement process, the amount shown is the loan principal that was left unpaid after the settlement. Box 5 describes the debt and box 7 reports the FMV of the property. In a foreclosure situation, the gross bid price from the foreclosure sale is shown as the FMV.

The Form 1099-C, like the Form 1099-A, must be filed by January 31 to the borrower and by February 28 with the IRS. If it is electronically filed, then the date for filing with the IRS is April 1. For purposes of Form 1099-C filing, "debt" means any amount owed to the lender including principal, interest, fees, penalties, administrative costs, and fines. The amount of debt cancelled may be all or only a part of the total amount owed.

For Form 1099-C purposes, "cancellation" can involve any the following:

- A discharge in bankruptcy under Title 11 for business or investment debt;
- The debt becoming unenforceable in a receivership, foreclosure, or similar court proceeding;
- The statute of limitations for collecting the debt has expired;
- The creditor elects foreclosure remedies that, by law, end the creditor's right to collect;
- A probate or similar proceeding;
- A discharge of indebtedness under an agreement between the creditor and the debtor to cancel the debt at less than full consideration;
- A discharge of indebtedness because of a decision or a defined policy of the creditor to discontinue collection activity and cancel the debt; or
- The expiration of a 36-month repayment testing period.

Some transactions are excepted from Form 1099-C reporting. These include:[76]

- Cancellation of nonbusiness or noninvestment debts in bankruptcy;
- The interest portion of cancelled debt;
- Nonprincipal amounts of cancelled debt;
- A foreign branch cancelling debt of a foreign debtor;
- Transfers of debt between related debtors (doesn't meet the definition of "cancellation");
- Release of a debtor on debt if other debtors are fully liable (doesn't meet the definition of "cancellation");
- When a guarantor is involved; or
- Transaction involving seller financing of nonfinancial goods or services, when the seller is not in the primary business of lending money.

Reporting the Income

Generally, cancelled debt (the amount reported in Form 1099-C, box 2) is reported on Form 1040, line 21, "Other Income" if it is nonbusiness debt. If it is business debt, it is reported on Schedule C, E, or F, as applicable. If any interest on the debt is also cancelled, it is included in the amount on Form 1099-C, box 2, and is also reported separately in box 3. If the interest **would not** be deductible when the taxpayer paid it (such as interest on a personal loan), the taxpayer should include the entire amount in income reported on Form 1099-C, box 2. If the interest **would** be deductible when the taxpayer had paid it (such as with a business loan), the amount included in income should be the amount on Form 1099-C, box 2, minus the interest amount shown in box 3.

76. Treas. Reg. §1.6050P-1

Not all cancelled debt is taxable.[77] The following exclusions apply:

- The discharge occurs in a title 11 case.
- The discharge occurs when the taxpayer is insolvent.
- The discharge is qualified farm indebtedness.
- The discharge is qualified real property business indebtedness in the case of a taxpayer other than a C corporation, or
- The indebtedness discharge is qualified principal residence indebtedness which is discharged before January 1, 2010.

Form 982 must be completed in order to claim these exclusions.

Some financial institutions offer a discount for the early payment of a mortgage loan. The amount of the discount is cancelled debt and must be reported in the borrower's income.

ISSUE 7: BANKRUPT DEBTOR'S RETURN PREPARATION

The preparation of a bankrupt client's tax return can present the practitioner with numerous issues. In general, the practitioner needs to adjust the calculation of the client's applicable credits and carry the pre-bankruptcy data forward to the post-bankruptcy period and manage the more specific aspects of the production of such returns. In the year of the client's bankruptcy, three types of bankruptcy returns may be filed:

1. The pre-bankruptcy return, which comprises all the relevant tax information until the date of bankruptcy;
2. The post-bankruptcy return, which includes all relevant tax information from the date of bankruptcy until the end of the year; and
3. The trustee's return, used for unincorporated businesses that are pursuing their activities at the date of bankruptcy under the supervision and control of a bankruptcy trustee.

Note. Usually, a bankruptcy trustee is assigned the task of having the bankruptcy returns prepared. The bankruptcy returns are the trustee's responsibility. However, the bankrupt taxpayer is usually required to file the post-bankruptcy return. Any refund is mailed to the bankrupt taxpayer.

The returns prepared for bankrupt taxpayers **cannot be filed electronically.**

PRE-BANKRUPTCY RETURN REQUIREMENTS

The pre-bankruptcy return reports all income, losses, and normal deductions of the bankrupt individual up to the day before the bankruptcy. This return is for a tax year with a deemed yearend on the day before the declaration of bankruptcy. Upon filing the bankruptcy petition, control of the individual's assets are transferred to the trustee. However, ownership remains vested in the bankrupt individual. Consequently, there is no deemed disposition and no terminal loss or depreciation recapture at this time. Since this is a short taxation year, depreciation must be prorated for the short fiscal year. A business operated by the bankrupt person does not have a deemed yearend and continues under the direction of the trustee. Hence, any income or loss from the business up to the bankruptcy date must be reported in the pre-bankruptcy return, and any income or loss from the business after the bankruptcy date must be reported on the trustee's return.

77. IRC §108

When preparing the pre-bankruptcy return, it is necessary to make reasonable estimates regarding the taxpayer and the taxpayer's spouse (if any). These estimates are helpful for the calculation of repayments of certain social program benefits, including child tax benefits and (for farmers) federal farm program benefits. In addition, all items of income, loss, deduction, and credit must be accounted for during the tax year up until the date of the bankruptcy petition. There may also be certain amounts carried forward from the pre-bankruptcy return to the post-bankruptcy return.

POST-BANKRUPTCY RETURN REQUIREMENTS

The post-bankruptcy return covers the period from the date of bankruptcy to December 31, and is treated as if the period covered is for a whole year. There are several key points that apply to the post-bankruptcy return:

- The return reports any income not included in the trustee's return (e.g. employment income).
- The return may not include loss carryovers of any kind. They are available only to the bankruptcy trustee.
- Personal credits may be claimed.

The post-bankruptcy return should also categorize the automatic carryforwards, other carryforwards, and the amount of income, losses, deductions, and other tax items arising post-petition.

> **Observation.** Typically, when the bankrupt taxpayer is not released from the bankruptcy or was released before the completion of the assessment of the post-bankruptcy return, the bankruptcy trustee eventually is sent any resulting tax refund. In order for the trustee to receive the refund, the return must include a document that indicates the bankrupt taxpayer has authorized the trustee to receive the refund.

TRUSTEE'S RETURN REQUIREMENTS

The trustee must file a return if the trustee has income or loss to report related to the bankrupt taxpayer's property and business during the period of the bankruptcy. The trustee's return may not claim any personal tax credits nor include any deductions in computing taxable income, except for loss carryovers. The trustee return is prepared on a Form 1041, and it must be filed by April 15 of the following year.

OTHER TAX RETURN PREPARATION ISSUES

- The **total nonrefundable tax credits** claimed by a bankrupt taxpayer in the year for both the pre-bankruptcy and post-bankruptcy periods cannot exceed the amount that could be claimed for the calendar year.
- **Personal tax credits** such as age and disability amounts and the transfers of unused credits are prorated by the number of days in the period for which the return is produced.
- Any **pension income** amount, amounts for **charitable donations**, **medical expenses**, and **tuition and education amounts** are based on the respective amounts pertaining to each period.
- If the bankrupt taxpayer is married, the **spouse's net income** for the entire year is included on the return. If the calendar year is not yet over at the time of the filing of the return, this amount may be an estimate if necessary. An adjustment may be made to the return at a later date. If the spouse is not bankrupt, the spouse's return must be calculated with the post-bankruptcy return of the bankrupt taxpayer.

INFORMATION GATHERING — LEGAL COUNSEL

The preparation of tax returns for a bankrupt debtor requires the accumulation of a great deal of information. It is likely that both legal and tax counsel are involved in any given situation. In many instances, it may be the case that legal and tax counsel are different persons or firms. As such, legal counsel may have acquired information from the debtor that can be useful to tax counsel.

The following is a suggested checklist for bankruptcy practitioners to use in generating the necessary information for a client facing bankruptcy. Tax preparers may find the checklist information useful in preparing debtors' tax returns.

Bankruptcy Tax Practitioner Checklist

The following information is needed in order for the practitioner to properly evaluate your situation. As with all communication between you and the practitioner, all the information supplied is strictly confidential. It is very important for you to supply all relevant information, because the practitioner cannot properly advise you without a complete understanding of your situation. If you are in doubt or have any questions, talk to your practitioner about it. Please be completely honest and candid when completing this form and in your communications with your practitioner.

Family Information:

Your name: ____________________ Your spouse's name (if applicable): ______________________

Current address: ______________________________________

☐ Never married ☐ Married, living together ☐ Married, living apart

☐ Living with a domestic partner ☐ Divorced ☐ Widowed

If divorced, when did it become final? ____________________

Number of dependent children: __________Any other person dependent on you? _______________

Your age: _____ Age of your spouse ______

☐ Are you or your spouse receiving any disability, workers' comp. or retirement income?

If so, how much per month? $______________

How long have you lived at your current address? __________

If less than two years, list each address that you have lived at during the past two years and the dates you lived there:

Asset Information:

List all real estate you own, when it was acquired, and its present value.

Location	Date Acquired	Value
		$
		$
		$

List anything given away, traded or transferred worth more than $1,000 in the past five years, including to family members.

Item	Value	Date Transferred	To Whom
	$		
	$		
	$		

List all bankruptcies you have ever filed and the outcome of the case.

Date	Chapter 7, 11, 13, 12	Outcome (dismissed or completed)

If you owe any money on any of your vehicles, list the type of vehicle, date purchased, and the amount owed.

Type of Vehicle	Date Purchased	Amount Owed

Have you closed any financial account (checking, savings, retirement, IRA, stock, mutual fund, Christmas club) in the past two years?

Type of Account	Date Closed	Value When Closed

Have you received, or are you entitled to any inheritance, property settlement agreement, or proceeds from a life insurance? YES ☐ NO ☐

Do you expect to receive any inheritance, property settlement agreement, or proceeds from life insurance within the next two years? YES ☐ NO ☐

Do you own or have any ownership interest in any business including partnerships?

Type of Business	Date Started (closed)	Annual Gross Income
		$
		$

Have you sold, transferred, or closed any business (or an interest in) within the past three years?

YES ☐ NO ☐

If "YES," please explain:

Financial Information:

List all retirement accounts you have an interest in (IRA, 401(k), union, government, military, profit-sharing).

Type of Account	Date withdrawals can start	Current Value
		$
		$
		$

List all financial accounts you have an interest in (checking, savings, CD, Christmas club, etc.).

Type of Account	Name of Bank, etc.	Current Balance
		$
		$
		$

Note. If any of the answers to the following questions are "YES" please explain on a separate sheet:

	Yes	No
Have you co-signed on a loan for anyone else?		
Do you have anything of yours in the possession or name of someone else?		
Do you have your name on anyone else's bank account, real property or vehicle?		
Are you suing anyone or have the right to sue them?		
Have you paid any family member any money in the past year (excluding support)?		
Have you filed all tax returns for the past three years?		
Have you made any major purchases (over $200) on any credit card in the past three months?		
Have you taken any cash advances in the past three months?		
Have you made any balance transfers on any credit card in the past three months?		
Do you own any money from a marital settlement or judgment of divorce?		
Have you been ordered to pay child or spousal support?		
Is any support past due?		
Does anyone owe you money for any reason?		
Do you have any claims against anyone or the right to sue anyone?		
Do you have any tax refunds due you at this time?		
Have you changed any payroll deductions within the past six months?		
Have you set up a trust in the past 10 years?		
Do you receive any income from a trust or annuity?		
Do you have income from royalties, gas or mineral rights, copyrights, licenses agreements or patents now or in the future?		
Do you have a life estate or the right to use anyone else's property?		
Do you own any stocks or bonds?		

☐ Do you have a storage unit? If so, what is in it? ____

____

☐ Do you have a safety deposit box? If so, what is in it? __________________________________

____

Anything else that you think your practitioner should be made aware of? _______________________

____

Date: _____________ Signature: ____________________________________

Spouse's Signature: ______________________________

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