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TAX ISSUES: 1398 SHORT YEAR ABANDONMENT OF PROPERTY CANCELLATION OF INDEBTEDNESS

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A CLE Presentation

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Election to Terminate Tax Year- “1398 Short Year”

Section 1398 of Internal Revenue Code

(d) Taxable year of debtors—

- (1) General rule. Except as provided in paragraph (2), the taxable year of the debtor shall be determined without regard to the case under title 11 of the United States Code to which this section applies.
- (2) Election to terminate debtor’s year when case commences.
 - (A) In general. Notwithstanding section 442, the debtor may (without the approval of the Secretary) elect to treat the debtor’s taxable year which includes the commencement date as 2 taxable years—
 - (i) the first of which ends on the day before the commencement date, and
 - (ii) the second of which begins on the commencement date.

Introduction

Section 1398 of the Internal Revenue Code (IRC), lays out the rules relating to an individual’s title 11 case, and only applies to bankruptcies filed under chapter 7 or 11. *26 U.S.C. § 1398(a)*. At the filing of bankruptcy, a separate entity is created, and generally the tax attributes into the bankruptcy estate are measured on January 1 in the year of bankruptcy unless an election is made by the individual debtor. There are two instances where the section 1398 election does not apply—when the case is dismissed, and at the partnership level. *26 U.S.C § 1398(b)*. Section 1398(d) allows a debtor to elect to divide their tax year into two short taxable periods. If a debtor chooses the short year election, then the first short tax year is closed the day before the bankruptcy case commences, and the second short tax year begins on the day the bankruptcy case commences.

According to section 1398(d)(2)(B) of the IRC, if the debtor is married and files a joint tax return for the first short tax period, then the debtor’s spouse may elect to have the short tax period. *26 U.S.C. § 1398(d)(2)(B)*. In enacting section 1398, Congress “recognized a need to accommodate both tax policy and bankruptcy’s fresh start policy.” *In re Fleming* 277 B.R. 751, 754 (S.D. Ohio 2002). Although there is an accommodation between fresh start policy and tax policy, it is necessary to make a timely election. *Id.* at 755. A “timely election” means that an election must be made “on or before the due date for filing the return for the taxable year referred to in subparagraph (A)(i).” *26 U.S.C. § 1398(d)(2)(D)*. Once the election is made, it is irrevocable. *Id.*

If the short year election is made, then the debtor’s federal income tax liability for the first tax year “becomes an allowable claim against the bankruptcy estate as a claim arising before the bankruptcy filing.” *Fleming*, at 755. However, if debtor does not make the election, then the “commencement of the bankruptcy case does not affect the individual’s taxable year.” *Id.* In addition, the income tax due for the year which the bankruptcy case was commenced is a post-petition obligation, and is collectible directly from the debtor, not the estate. *Id.* If there are no assets other than exempt property, then the section 1398 election is not available to the debtor. *26 U.S.C. § 1398(d)(2)(C)*.

Estate succeeds to tax attributes of debtor

Section 541(a)(1) of the bankruptcy code describes the scope of the estate. In addition, this section is “intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code.” *In re Antonelli*, 150 B.R. 364, 365 (D.C. 1992). In addition, some of these provisions “bring into the estate property in which the debtor did not have a possessory interest” when the bankruptcy proceedings commenced. *Id.* An example of such a provision is section 346 of the Bankruptcy Code, which addresses special tax provisions, including tax attributes of the debtor that the estate shall succeed. Also in section 346, however, is a mandate that federal tax law “takes precedence over the tax provisions of the Bankruptcy Code... As a result, the court must apply the applicable revenue code provisions.” *Id.*, at 366.

The estate succeeds to the following tax attributes of a debtor:

- (1) Net operating loss carryovers
- (2) Charitable contributions carryovers
- (3) Recovery of tax benefit items
- (4) Credit carryovers, etc.
- (5) Capital loss carryovers
- (6) Basis, holding period, and character of assets
- (7) Method of accounting
- (8) Other attributes (“to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section”)

26 U.S.C. § 1398(g). This list is “exhaustive,” and when one court was asked to include an attribute not listed in section 1398(g), that court held that “it could not do so due to the unambiguous nature of the statute and the power which is specifically granted to the Secretary.” *Antonelli*, at 366. The court in *Antonelli* was asked to include passive activity losses as a tax attribute because they are “so closely related to net operating loss carryovers and capital loss carryovers.” *Id.*, at 367. The court declined to do so since passive activity losses are “unique in nature” and cannot be compared to the tax attributes in section 1398(g). *Id.* The *Antonelli* court added that section 1398(g)(8) “grants exclusive authority to the Secretary to add to the statutory list.” *Id.*

Dismissal of the Bankruptcy case

Section 349 of the Bankruptcy Code deals with the effect of a dismissal, and once a case is dismissed, the property of the estate is re-vested in the entity in which this property was vested immediately before the commencement of the case. 11 U.S.C. § 349(b)(3). As for the tax implications of a dismissal, section 1398(b)(1) of the IRC states that if a chapter 7 or 11 bankruptcy case is dismissed, then section 1398 will not be applicable. 26 U.S.C. § 1398(b)(1). If the case is dismissed, then “the bankruptcy estate never becomes a separate taxable entity for which the trustee must prepare and file federal income tax returns.” *In re Parsons*, 272 B.R. 735, 750 (D. Colo. 2001). This means that the debtor reports the transactions of the estate. In addition, post-dismissal sale of assets by the trustee and property sold during pendency of bankruptcy case creates tax consequences for the debtor once a dismissal order is granted. In essence, the “former debtors lose the tax advantages that would have obtained had the case not been dismissed.” *In re Stahley* 7 Colo. Bankr Ct. Rep. 75, 80 (D. Colo. 1990).

Abandonment of Property

Section 554 of Bankruptcy Code

- (a) After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate.

According to section 554(a) of the Bankruptcy Code, the trustee has the power to abandon the property. Property that has been abandoned pursuant to this section ceases to be a part of the estate—it reverts back to the debtor, and stands as if no bankruptcy petition had been filed. Following abandonment, whoever had possessory right to property at filing of bankruptcy reacquires that right. Although the automatic stay continues as to the property abandoned to the debtor, it does not continue to bar replevin action. Section 362(c)(1) states “the stay of an act against property of the estate under subsection (a) of this section continues until such property is no longer property of the estate”. 11 U.S.C. § 362(c)(1).

In general, gain or loss is not considered for tax purposes until it is realized. This occurs upon the happening of a taxable event, such as a sale or exchange of property. This means that the act of a trustee abandoning the property would generally not be a taxable event. In addition, the amount of gain that is subject to taxation is generally measured by taking the “difference between the basis of the property and the value of the consideration received. Absent a specific non-recognition provision in the Internal Revenue Code, the entire amount of gain realized on the sale or exchange of property must be

recognized as income in the taxable period in which such sale occurs.” *In re Perlman*, 188 B.R. 704, at 708 (S.D. Fla. 1995).

There is conflicting caselaw with respect to whether at the time of abandonment tax consequences arise for the estate. A case that appears to be in the minority view is from Massachusetts, *In re AJ Lane & Co, Inc.* 133 B.R. 264 (D. Mass. 1991). This court held that the Chapter 11 trustee’s proposed abandonment of mortgaged property to debtor, at a hearing several weeks prior to scheduled foreclosure sale and prior to closing of the case would be a taxable event. This would be taxable to the bankruptcy estate rather than the debtor (based on § 1398 (f)(2) and (i) of the IRC). In addition, the court held that this proposed abandonment was an attempt to place “form over substance by substituting different seller in pending sales transaction. Under Court Holding doctrine, such a scheme would be unsuccessful; the estate would still be taxed on the foreclosure sale.” *Lane* at 275. The court added that the tax burden would inhibit the debtor’s fresh start, and that the Bankruptcy Code provisions, such as the abandonment provision, should be interpreted with basic bankruptcy policies in mind, including the policy of promoting fresh start for the debtor. *Id.* The “Court Holding” doctrine mentioned in *Lane* is:

The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. *Commissioner v. Court Holding Co.* 324 U.S. 331, at 334 (1945).

A more recent decision in the 9th Circuit did not adopt the *Lane* holding, but instead held what most of the circuits have held—that an abandonment of estate property by a trustee is not a sale or exchange which triggers tax liabilities chargeable to the estate. The court held in *In re Johnston* 49 F.3d 538 (9th Cir. 1995), that property which is of inconsequential value and benefit to the estate may be abandoned under section 554(a) of the Bankruptcy Code, regardless of whether or not it will shift tax consequences to debtor.

In *Johnston*, a trustee was appointed in October of 1990, and his main task was to sell the debtor’s estate to satisfy creditor’s claims. To fund the operation of the property and sales efforts, the trustee borrowed \$525,000, and secured it with the property. In August of 1992, a creditor holding a first deed of trust obtained relief from the automatic stay, and recorded notice of sale. At this time, the trustee had the property reappraised and determined that the price the estate would get on the market would not cover the funds required to pay off the encumbrances, and pay taxes. The trustee determined that the tax basis was such that the sale would generate about \$2 million in capital gain. In October of 1992, the trustee moved to abandon the property, because it was of inconsequential value and burdensome to the estate because the impending foreclosure sale would generate a taxable event with substantial adverse tax consequences to the estate.

The debtors in *Johnston* wanted the Ninth Circuit Court of Appeals to adopt the rationale of *Lane*, but the court declined to do so, and instead distinguished the two cases. The court in *Johnston* notes that in *Lane*, the trustee’s argument that the property was of inconsequential value and benefit to the estate was rejected by the court, and “the trustee had to rely on the ‘burdensome’ prong of § 554(a).” *Johnston*, at 540. In *Lane*, the court rejected the argument that the property was burdensome, because if it were sold pursuant to the foreclosure sale while it was still within the estate, the estate would realize a large tax liability. The *Lane* court held that “abandonment of over encumbered property was a ‘sale or exchange’ or property giving rise to tax liability...[and] that a transfer of property already the ‘subject of a sales transaction’ to another for the sole purpose of having the other party taxed on the sale was ineffective to shift the tax consequences under *Court Holding Co.*”; and that the abandonment did not come within the reach of 26 U.S.C. § 1398(f)(2).” *Johnston*, at 540.

In sum, the Johnston court held that the discussion in Lane “is not pertinent to the question of whether tax consequences to the debtor may properly be taken into account if the statutory requirement that the property is otherwise of inconsequential value and benefit to the estate is met.” Id. at 541. The Ninth Circuit also rejected the notion that abandonment would burden the debtor’s fresh start. In doing so, the Johnston court mentioned that there are times when there may be some tension between the purpose of section 541(a) and the fresh start policy. The court first looked to the language of section 541(a), and noted that “[i]mpact on the debtor is not listed as one of the factors to be considered in authorizing abandonment.” Johnston, at 541. In addition, the court looked to the other sections of the Bankruptcy Code, and that the Code does not allow a fresh start with respect to taxes in general. For example, a “Chapter 11 plan may not be approved over the IRS’s objection unless it provides for full payment of these priority tax claims.” Id. In addition, priority tax claims are not dischargeable. Thus, the Ninth Circuit concludes that the Bankruptcy Code provisions dealing with taxes are “not consonant with the notion that Congress intended to bar debtor taxation on such transfers as a matter of Bankruptcy Code policy.” Id.

It is a different matter altogether if a trustee attempts to abandon the property, where prior to seeking abandonment, a trustee sold property. According to In re Perlman, 188 B.R. 704 (S.D. Fla. 1995), this action would considered be a taxable event under the IRC, and cannot be undone by attempted retroactive abandonment of assets or by abandonment of sale proceeds, which proceeds are property of estate. In this case, trustee did not know of the potentially significant tax consequences at the time he sold the properties, because the debtor had not filed tax returns for two years prior to the petition. After the sale, the trustee learned the tax liability may far exceed the proceeds from the sales, and argued that the court should allow the abandonment in order to protect the estate and unsecured creditors from this potentially substantial tax burden. The court rejected this argument, and held that “[t]here is simply no retroactive escape from the tax consequences triggered by the sales.” Perlman, at 708.

If a trustee abandons property, and is later sold, the debtor will be stuck with a non-dischargeable tax liability. One way to avoid this is to surrender the property under section 521, in the statement of intentions. This way, there will not be a sale or exchange, and therefore no tax consequences.

There may be a potential claim against trustee for gross negligence, if, for example, the property was not in default when the trustee took the property into the estate, but after abandoning months or years later, causes a foreclosure sale.

Scenario

- A debtor comes in and has commercial property worth \$600,000, and has a \$400,000 mortgage, \$100,000 of unsecured debt and \$100,000 of payroll taxes and other non-dischargeable taxes. What do you do?

Cancellation of Indebtedness

Section 108 of Internal Revenue Code

(a) Exclusion from gross income—

(1) In general. Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

- (A) the discharge occurs in a title 11 case,
- (B) the discharge occurs when the taxpayer is insolvent,
- (C) the indebtedness discharged is qualified farm indebtedness, or
- (D) in the case of a taxpayer other than a C corporation, the indebtedness discharge is qualified real property business indebtedness...

(b) Reduction of tax attributes—

- (1) In general. The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).
- (2) Tax attributes affected; order of reduction. Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:
 - (A) NOL. Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.
 - (B) General business credit. Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).
 - (C) Minimum tax credit. The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.
 - (D) Capital loss carryovers. Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.
 - (E) Basis reduction.
 - (i) In general. The basis of the property of the taxpayer.
 - (ii) Cross reference. For provisions for making the reduction described in clause (i), see section 1017.
 - (F) Passive activity loss and credit carryovers. Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.
 - (G) Foreign tax credit carryovers. Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

Introduction

Under the general principles of income recognition, the borrowing of money is not a taxable event, because the borrower has assumed an obligation to repay the debt in full at a later date. However, when that debt is cancelled or discharged, then section 61(a)(12) of the Internal Revenue Code (IRC) will apply. Gross income is defined as “all income whatever sources derived,” and section 61(a) lists items that are considered gross income. Section 61(a)(12) states that “income from discharge of indebtedness” is included in gross income. 26 U.S.C. § 61(a)(12).

Whenever a taxpayer, who had incurred a financial obligation, is relieved of liability, in whole or in part, the discharge of indebtedness income doctrine is applicable. At this point, the taxpayer recognizes income “equal to the difference between the initial obligation and the amount, if any, paid to discharge that obligation.” *Smith v. Commissioner*. 198 F.3d 515, at 530 (5th Cir. 1999).

The cancellation of indebtedness may include situations where a debtor performs a service for a creditor, who in turn cancels the debt, then the debtor realizes as gross income the amount of the debt as compensation for the services. 26 CFR 1.161-12(a). In addition, income may be realized by the payment or purchase of obligations at less than their face value. 26 CFR 1.161-12(a).

There are two rationales for the discharge of indebtedness rule, these were stated in *Preslar v. Commissioner* 167 F.3d 1323, at 1330 (10th Cir. 1999). The first rationale is that the rule is “based on the premise that the taxpayer has an increase in wealth due to the reduction in valid claims against the taxpayer's assets.” *Id.*, at 1327. Another rationale that has been suggested is that “taxation is appropriate because the consideration received by a taxpayer in exchange for [his] indebtedness is not included in income when received because of the obligation to repay and the cancellation of that obligation removes the reason for the original exclusion.” *Id.*

There are ways for a taxpayer to reduce this discharge of indebtedness income, such as purchase price adjustment discussed below. In addition, section 108(a)(1) of the IRC lists four exceptions, where discharge of indebtedness income may be excluded from gross income, and any income received from a discharge of liability would not be subject to income taxation.

Debts forgiven

In order for discharge of indebtedness income to occur, the taxpayer, who had incurred a financial obligation, must be discharged from liability, whether in whole or in part, or has compromised or settled the debt for less than the face amount, or amount due. "Indebtedness" is defined as, "an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount." Preslar, at 1330.

A debt is viewed as being discharged, for the purposes of section 61(a)(12) of the IRC, "when it becomes clear that the debt will never have to be paid." Friedman v. Commissioner, 216 F.3d 537, 546 (6th Cir. 2000). The test that the court used in Friedman to determine whether a debt was discharged, was also used in Brountas v. Commissioner 74 T.C. 1062 (1980). Whether it is "absolutely impossible" for a debt to be repaid is based on the practical worthlessness of a debt, it is not necessarily the point at which a creditor could deduct for a bad debt. Brountas at 1074. The test for when a debt is viewed as being discharged is "when only an incorrigible optimist would expect repayment." Id. In addition, in Cozzi v. Commissioner, 88 T.C. 435 (1987), the court held that whether a debt has been discharged, "is dependent on the substance of the transactions. Mere formalisms arranged by the parties are not binding in the application of the tax laws." Cozzi at 1074. Further, "[a]ny 'identifiable event' which fixes the loss with certainty may be taken into consideration." Id. at 445.

Contested Liability/Disputed Debt Exception

The contested liability exception to discharge of indebtedness income, or COD income, is based on the premise that "if a taxpayer disputes the *original amount* of a debt in good faith, a subsequent settlement of that dispute is 'treated as the amount of debt cognizable for tax purposes.'" Preslar at 1327. If this exception is applicable, then "the 'excess of the original debt over the amount determined to have been due' may be disregarded in calculating gross income." Id. According to the Preslar court, "[t]he few decisions that have interpreted this doctrine have generated considerable controversy." Id.

For example, the Third Circuit in Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990), held that Zarin had no COD income because his transaction arose from a contested liability. The Preslar court criticized Zarin because the Third Circuit failed to distinguish between liquidated and unliquidated debts, instead treating them alike. Preslar at 1328. In addition, the court in Zarin did not recognize the difference between disputes about the amount of debt, and the enforceability of a claim for a certain sum.

The court in Preslar states that the "mere fact that a taxpayer challenges the enforceability of a debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute." Id. Further, the court held that in order to utilize this contested liability doctrine, the original amount of the debt must be unliquidated. Id.

There might be a situation, as found in Exchange Sec. Bank v. United States, 345 F. Supp. 486 (N.D. Ala. 1972), in which a debtor may actually owe the debt, and the creditor, knowing that debtor will deny liability, wants to settle, to save time and expense of litigation, and will accept a smaller payment than actually owed. In addition, if there are real problems of proof or collectability, the creditor might even dismiss the suit without any payment. In these types of situations, the debtor would realize discharge of indebtedness income, "subject to the 'insolvency' and 'gift' exceptions." Id. at 491. Essentially, the settlement of a contested liability or disputed debt "may or may not result in cancellation-type income." Id.

Purchase Price Adjustment Exception

In addition to the contested liability exception, section 108(e)(5) carves out another way for a taxpayer to avoid discharge of indebtedness income. Basically this rule allows the taxpayer to “reflect their debt reduction by adjusting the basis of their property rather than recognizing an immediate gain as cancellation of indebtedness.” *Preslar*, at 1331. There is a purchase-money debt reduction for a solvent debtor treated as a price reduction if “the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced, such reduction does not occur—in a title 11 case, or when the purchaser is insolvent, and but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness, then such reduction shall be treated as a purchase price adjustment.” 26 U.S.C. § 108(e)(5). The court in *Preslar* noted that this section only applies “to direct agreements between a purchaser and seller.” *Preslar*, at 1331.

In limited circumstances, the purchase price adjustment is available in a situation besides the direct seller-purchaser transaction. This is the “infirmity exception,” which allows a taxpayer to “treat debt reductions negotiated with third parties as purchase price adjustments ‘to the extent that the debt reduction by the third-party lender is based on an infirmity that clearly relates back to the original sale (e.g., the seller’s inducement of a higher purchase price by misrepresentation of material fact or by fraud).” *Id.* at 1333.

Section 108(a)(1) Exceptions

Bankruptcy

According to section 108(a)(1)(A) of the IRC, income is not realized by a taxpayer who receives a discharge of indebtedness under a title 11 case. Section 108(d)(2) of the IRC, a “title 11 case” is as “a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.” 26 U.S.C. § 108(d)(2).

In any case under chapter 7 or 11 of title 11 of the United States Code, to which section 1398 of the IRC applies, for purposes of section 108(b)(1) of the IRC, the estate (not the individual) shall be treated as the taxpayer. 26 U.S.C. § 108(d)(8). This refers to the reduction of tax attributes in title 11 cases of individuals to be made by the estate.

Insolvency

There is an insolvency exception to the general rule of taxability of a discharge of indebtedness. It applies when the borrower is insolvent, both before and after the forgiveness of debt. As a result, the debtor will not recognize income under section 61(a)(12). However, if the discharge makes the debtor solvent, the debtor must recognize income to the extent that the debtor is solvent after the debt reduction.

The term “insolvent” is defined in section 108(d)(3) of the IRC, as “the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer’s assets and liabilities immediately before the discharge.” The term “liabilities” is not defined in the IRC, and section 108(d)(3) does not state how likely the occurrence of a contingency must be in order for the obligation to count as a liability. According to Black’s Law Dictionary, “liability” is broadly defined, “including almost every character of hazard or responsibility, absolute, contingent, or likely.” *Black’s Law Dictionary* 914 (6th ed. 1990).

Now the question is just how remote of a contingency should be taken into consideration in determining insolvency. According to the Ninth Circuit in *Merkel v. Commissioner*, 192 F.3d 844 (9th Cir. 1999), if all contingent liabilities were included in the calculation of insolvency, no matter how remote, this “could lead to the absurd result of the insolvency exception swallowing the general rule that discharge of indebtedness income be included in gross income.” *Id.* at 848. The court in *Merkel* held that a taxpayer claiming to be insolvent under section 108(a)(1)(B) of the IRC, must “prove by a preponderance of the

evidence that he or she will be called upon to pay an obligation claimed to be a liability and that the total amount of liabilities so proved exceed the fair market value of his or her assets.” *Id.* at 850.

If a taxpayer is allowed to exclude discharge of indebtedness income because of the insolvency exception, any tax attributes that the taxpayer has in relation to the debt must be reduced by the amount of the exclusion.

Qualified farm indebtedness

There are special rules for the discharge of qualified farm indebtedness. See 26 U.S.C. § 108(g). First, in order for section 108(a)(1)(C) to apply, the discharge must be by a qualified person. A “qualified person” is defined as “any person which is actively and regularly engaged in the business of lending money and which is not-- (I) a related person with respect to the taxpayer, (II) a person from which the taxpayer acquired the property (or a related person to such person), or (III) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).” 26 U.S.C. 49(a)(1)(D)(iv). According to section 108(g)(1)(B), the term “qualified person” includes “any Federal, State, or local government or agency or instrumentality thereof.” 26 U.S.C. § 108(g)(1)(B).

The indebtedness of a taxpayer is treated as “qualified farm indebtedness” if, “(A) such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and (B) 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.” 26 U.S.C. § 108(g)(2).

In general, the amount excluded under section 108(a)(1)(C), shall not exceed the sum of, “(i) the adjusted tax attributes of the taxpayer, and (ii) the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.” 26 U.S.C. § 108(g)(3).

Qualified real property business indebtedness

According to section 108(c)(3), “qualified real property business indebtedness” means indebtedness that “was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property, was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and with respect to which such taxpayer makes an election to have this paragraph apply.” 26 U.S.C. § 108(c)(3). This does not include qualified farm indebtedness, however.

If there is a discharge of qualified real property business indebtedness, then the amount excluded under section 108(a)(1)(D) “shall be applied to reduce the basis of the depreciable real property of the taxpayer.” 26 U.S.C. § 108(c)(1). There are limitations, however, for indebtedness in excess of value. The amount excluded in section 108(a)(1)(D) shall not exceed the excess of, “the outstanding principal amount of such indebtedness (immediately before the discharge), over the fair market value of [real property used in trade or business], reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property...” 26 U.S.C. § 108(c)(2)(A). In addition, the amount excluded shall not exceed the aggregate adjusted bases of depreciable real property held by the taxpayer right before the discharge. 26 U.S.C. § 108(c)(2)(B). One important note is that section 108(b)(1) is not applicable to the qualified real property business indebtedness. Section 108(b)(1) states that the amount excluded from gross income shall be applied to reduce the tax attributes of the taxpayer. Section 108(b)(1) only applies to the first three exceptions listed in section 108(a)(1).