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A COMMENT ON THE TAX PROVISIONS OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION REPORT: THE GOOD, THE BAD, AND THE UGLY

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Being asked to comment on the tax provisions of the National Bankruptcy Review Commission Report ("Commission Report") [1] is a lot like being asked to criticize one's relatives; regardless of the blemishes and warts, they look just fine to me. So it goes with the tax section of the Commission Report. [2] As Chair of the Tax Advisory Committee ("Advisory Committee"), I was privileged to work with nine outstanding experts in the field of bankruptcy taxation. [3] Our efforts bore fruit in the form of a tax report of over 130 pages, addressing a number of the most difficult issues in tax and insolvency law. The complete tax report is attached as an appendix to the Commission Report and had a significant impact on tax recommendations made by the National Bankruptcy Review Commission ("NBRC"). [4]

Obviously, a short comment on the tax provisions of the Commission Report is impossible; consequently, I will exercise my prerogative as author and focus on just a few of the proposals adopted by the NBRC. The proposals I will discuss are not necessarily the most important or the most controversial; they have, however, potential widespread impact on the complexion of bankruptcy law and practice.

Before I begin the substantive comments, let me paint for you a picture of how the NBRC tax proposals were adopted. Under the auspices of the NBRC, the Advisory Committee was formed in February 1997. [5] The members of the Advisory Committee were appointed by the NBRC and include representatives from the private bar, federal and state governments, and academia. [6]

The NBRC's charge to the Advisory Committee was broad, including the jurisdiction to propose and discuss all issues related to federal, state, and local tax collection, compliance, and reporting related to bankruptcy, the bankruptcy

process, and the administration of the bankruptcy estate. [7] By necessity, this charge included an analysis of existing authority under both the Bankruptcy Code [8] and the Internal Revenue Code. [9]

The NBRC directed that the Advisory Committee report back by way of a Final Report by the August 1997 meeting in Washington, D.C. [10] The NBRC further requested that the Advisory Committee prepare Preliminary Reports for the April 1997 meeting of the NBRC in Seattle, Washington, and the June 1997 meeting in Detroit, Michigan. [11] The Preliminary Reports identified those areas of bankruptcy taxation that the Advisory Committee had determined were susceptible to agreement among its members and those proposals that had been withdrawn from consideration by the Advisory Committee as unimportant, unclear, or considered elsewhere. [12] The Advisory Committee continued the process of discussing and identifying those proposals that may be susceptible to agreement. [13] The Final Report contains three sections. [14] The first section contains a listing and discussion of twenty−eight consensus items. [15] The first twenty−five of the twenty−eight items were presented to the NBRC at the May 1997 meeting and twenty−four of the items were adopted unanimously. [16] The second section contains a listing and discussion of six items that would have been consensus items but for the federal participants on the Advisory Committee abstained from consideration of these proposals. [17] The third section contains a listing and discussion of twenty−nine proposals concerning those areas of bankruptcy taxation that the Advisory Committee determined were very important and highly controversial to controversial. [18] Although short of a consensus on these contested issues, the Advisory Committee provided to the NBRC its recommendations and voting record on the twenty−nine proposals. [19]

Before the Advisory Committee was formed, much work on the interface between bankruptcy and tax had been accomplished. [20] The Department of Treasury, through the Internal Revenue Service ("IRS"), and the Department of Justice prepared working papers on relevant topics and proposals, and participated informally in discussions. [21] The National Association of Attorneys General submitted a number of tax proposals for consideration. [22] The NBRC held two working meetings in San Diego, California, and Santa Fe, New Mexico, where many bankruptcy taxation issues were discussed and developed. [23] NBRC member James I. Shepard has studied the tax issues posed in the bankruptcy process extensively, [24] furthermore, the Government Working Group discussed several tax issues. [25] The Special Task Force on the NBRC, of the Section of Taxation of the American Bar Association, prepared an extensive report on bankruptcy tax issues. [26] The National Bankruptcy Conference prepared a report on bankruptcy tax issues. [27] Judges, trustees, and other concerned parties have submitted proposals for consideration by the Advisory Committee and the NBRC. [28] The combined efforts of the parties described above have led to the development of a Tax Matrix in excess of ninety pages with well over 100 proposals. [29] While many of the proposals adopted by the NBRC were recommendations by the Advisory Committee, on occasion the NBRC rejected the recommendation of the Advisory Committee and adopted one of the competing proposals. [30]

Although the proposals actually adopted by the NBRC address difficult and controversial tax issues, I will discuss only four of the proposals three of which I will call the good, the bad, and the ugly.

I. The Good: Requirement to File Returns in Chapter 13 Cases.

The NBRC has adopted the recommendation of the Advisory Committee on filing return requirements in chapter 13 cases. [31] Assistant Attorney General Mark Browning of Texas (with help from Steve Csontos of the United States Justice Department) essentially proposed the framework and drafted what was to become Recommendation 4.2.22. [32] The proposal contains several requirements that will dramatically change the landscape of chapter 13 practice if adopted by Congress.

First, the NBRC proposes that a debtor must file tax returns for all tax periods ending within six years prior to the petition date as a prerequisite for confirming a chapter 13 plan. [33] The requirement for six years of returns reflects a compromise on the part of tax authorities, who generally oppose discharge in bankruptcy for *any* period for which a debtor/taxpayer has failed to file returns. [34] Although any time period is arbitrary, a specific requirement that embraces a reasonable term of years is far superior than an ambiguous standard.

Second, the NBRC proposes that a debtor must properly file prepetition tax returns with the appropriate tax authorities at least one day prior to the conclusion of the first meeting of creditors. [35] A debtor will evidence the satisfaction of this requirement by filing with the court a statement certifying, under penalty of perjury, that all required tax returns for the relevant periods have been properly filed with the appropriate tax authorities. [36] The chapter 13 trustee may require that a debtor submit copies of returns to the trustee. [37] The requirement that returns be filed at least one day before the completion of the section 341 meeting allows a chapter 13 trustee to ask meaningfully whether the debtor's plan provides for payment of the amount of taxes reflected in the filed returns. [38] If the proposed chapter 13 plan does not provide for payment matching the tax shown on the filed returns, then presumably the trustee would not recommend confirmation. [39]

Third, the NBRC proposes that if a debtor has not filed tax returns by the date on which the first meeting of creditors commences, a chapter 13 trustee may continue the first meeting to allow additional time to file returns. [40] Under the proposal, a chapter 13 trustee may extend the time no longer than: (1) 120 days from the order for relief for returns that are past due as of the order for relief; or (2) for returns not past due as of the order for relief date, the latter of 120 days from the petition date or the automatic extension date for filing a return under applicable tax law. [41] This provision in the proposal also reflects a compromise on the part of tax authorities and debtors. [42] A stricter standard requiring tax returns be current as of the date of the order for relief might delay or deny bankruptcy relief to debtors who need it for nontax reasons (pending home foreclosure or car repossession, for example). A looser standard allowing returns to be filed up until the government claim bar date (180 days from petition date) would put large−volume tax authorities under an unrealistically short deadline to file or amend claims and create havoc or delays in the confirmation process. The anticipated procedure is that the trustee would determine at the initial section 341 meeting if a debtor has filed necessary tax returns. [43] If not, but the trustee is satisfied that the debtor is making a

reasonable effort to prepare and file returns, the trustee may continue the section 341 meeting for up to 120 days or until the last available extension for a prepetition return. [44]

Fourth, the NBRC proposes that a debtor's failure to file timely tax returns by the above deadline for prepetition returns, or by due dates (including extensions pursuant to applicable tax laws) for postpetition returns, should constitute cause for conversion or dismissal under section 1307(c). [45] Rather than automatic dismissal for failure to file tax returns (a position tax authorities had originally advocated), the failure to file necessary returns would be added to the other "causes" for dismissal or conversion contained in section 1307. [46] Most courts now dismiss or convert cases when debtors have failed to file tax returns. [47] This NBRC Recommendation would codify that practice. [48]

Fifth, the NBRC proposes that a court, for good cause shown and due to circumstances for which the debtor should not justly be held accountable, may extend the return−filing deadline. [49] Dismissal or conversion would be automatic if such extended deadline were missed. [50] This provision of the proposal provides a "safety valve" in case a debtor has made a good faith effort to get returns prepared and filed, but for unanticipated reasons beyond the debtor's control (delay in receiving necessary information from tax authorities or incapacitating injury, for example) has been unable to do so. [51] Again, this provision is a compromise on the part of tax authorities, whose initial preference was for an absolute cutoff point for filing returns. [52]

Sixth, the NBRC proposes the deadline for objecting to plan confirmation should be at least sixty days after prepetition tax returns are filed with the tax authorities. [53] This provision of the proposal addresses two issues: (1) how long should tax authorities be given to act upon filed returns; and (2) can confirmation of a chapter 13 plan proceed before priority tax debts have been determined? [54] From the perspective of debtors and other creditors, problems are created when the entire bankruptcy process must be put on hold while tax authorities determine what they are owed. [55] The proposed sixty−day period would force tax authorities to act in a reasonably prompt manner to protect their claims at confirmation. [56] From the tax authorities' perspective, it is a considerable waste of time and effort either to estimate (and later amend) claims for tax periods for which no returns have been filed or to file a "place−holding" confirmation objection until the extent of the claim is determined. [57] This provision attempts to strike a reasonable balance: debtors must file returns before confirmation can proceed, but the confirmation process can proceed fairly quickly after returns are filed. [58]

This provision also seeks to terminate the misguided practice in some districts of confirming chapter 13 plans before the amount of priority tax debt is known. [59] This practice creates a number of complex legal and practical issues. For example, how can a court fairly assess feasibility of a plan under section 1325(a)(6) if the amount of priority tax debt that must be paid in full cannot be determined? Taking a debtor's word for the amount owed, or simply ignoring the issue, is contrary to reason and common sense. From a procedural standpoint, confirmation of a plan before tax debts are determinable results in a "preliminary confirmation order." Are such orders appealable as final orders? Do they have res judicata effect on tax creditors, or on other creditors if modification is required in the future? Who is responsible for undoing or modifying the preliminary confirmation order after tax claims are filed? What is the standard of proof when seeking to overturn or vacate such orders? Who has the burden of proof? These unnecessary and difficult questions are eliminated under the NBRC Recommendation. [60] Debtors, who are delinquent in filing prepetition returns, are taken off the "confirmation fast track" as long as the delinquency continues. [61] Debtors who are current on their returns as provide in this proposal remain on the fast track in jurisdictions that do early confirmations. [62] While the NBRC recommendation does result in disparate treatment, such treatment is not out of line in this context because the provision rewards debtors who have complied with the tax laws (or who promptly cure noncompliance) and delays those who are delinquent. [63] From a procedural and policy standpoint, more time *should* be taken to deal with debtors who have difficulty bringing their tax returns current. [64] Failure to file tax returns is often indicative of other financial problems that need to be addressed, and the proposal above would serve to red flag potential problem cases needing extra attention, appropriately taking them off the confirmation "fast track." [65]

Seventh, a debtor may not file an objection to a proof of claim for a tax required to be reported on a return unless the debtor has filed a return for that tax. [66] This is so basic that it needs no further explanation. Practice in some districts to the contrary is fundamentally unfair.

Finally, the proposal would modify the special governmental bar date for tax claims only to allow tax authorities sixty days from the filing of tax returns by debtors to file proofs of claim; provided, however, that the modification will not have the effect of shortening the governmental bar date in any case. [67] As noted above, the practice of filing estimated "place holding" proofs of claim for periods for which no returns have been filed creates a number of problems for tax authorities, debtors, and courts. [68] Tax authorities must spend considerable time and effort preparing debtor−specific estimated proofs of claim, which is a monumental task given the volume of chapter 13 filings. [69] The task is unnecessary if debtors comply with filing obligations applicable to nondebtors, and the effort is simply wasted if returns are later filed and processed into amended proofs of claim, thereby mooting the estimated claims. [70] Further, tax authorities are in a "no−win" situation on estimated proofs of claim. [71] Some courts have directed tax authorities to file claims labeled as estimates to protect their position, [72] while other courts have sanctioned tax authorities for filing incorrect estimates. [73] Debtors resent estimated proofs of claim that may overestimate the amount of taxes owed, and "burden of proof" procedural battles often erupt in such cases. [74] Courts are faced with hearing claim disputes with a dearth of evidence. [75] To avoid such difficulties, the proposal contains a simple rule: returns must be brought current before debtors can proceed with claim objections. [76] Consistent with the intent to eliminate "place−holding" estimated proofs of claim, adjustment to the governmental claims bar date is proposed allowing the filing of allowed tax claims based upon the returns filed by debtors, rather than estimates. [77]

This proposal represented months of heated debate and negotiation among members of the Advisory Committee. The proposal went through several iterations before it was approved for recommendation by the Advisory Committee and adopted by the NBRC. If enacted, this proposal will have far−reaching effect, changing the face of chapter 13 practice in most districts. It was the Advisory Committee's finest hour.

II. The Bad: Rejection of Modifications to Chapter 13 Discharge

The Advisory Committee entertained and debated several proposals seeking to reject, modify, or reaffirm the present scope of the chapter 13 discharge as it relates to tax claims. [78] Ultimately, the Advisory Committee did not reach agreement on any proposal. The NBRC also failed to reach agreement on any of the proposals, thus, in effect, voting to retain the scope of the chapter 13 discharge.

Arguments for retention of the chapter 13 discharge are well documented. [79] Chapter 13 provides a more robust discharge in return for greater recovery for creditors then they would have received in a chapter 7 case. [80] The superdischarge breathes life into the fundamental bankruptcy policy of providing an individual debtor a fresh start. [81] The requirements that every plan must be proposed in good faith [82] and be in the best interests of the creditors [83] serve as sufficient gatekeepers to deter bad faith and abuse of the process.

Nonetheless, the IRS proposed to conform the discharge of chapter 13 to that of chapter 7. [84] Essentially, the IRS sought to eliminate the superdischarge of priority taxes in a chapter 13 case, and clarify that postpetition taxes for which a proof of claim is filed under section 1305(a)(1) are not subject to discharge. [85] The proposal would align the chapter 13 exceptions to discharge to those of chapter 7 and an individual under chapter 11. [86] The Bankruptcy Code now discharges a chapter 13 debtor from taxes that are provided for by the plan or are disallowed under section 502. [87] Several courts have held that priority taxes mentioned in the plan are "provided for" and can be discharged whether or not they are actually paid. [88] Similarly, claims for priority taxes that have been disallowed in the bankruptcy cases under section 502 and would not be dischargeable in a chapter 7 [89] or 11 case have been held to be dischargeable because they were provided for in a chapter 13 plan. [90] The problem most often arises in those cases where the IRS's claim was untimely filed [91] or where the IRS failed to file a claim at all. [92] The most serious concern of the IRS occurs with derivative liabilities, where the debt is prepetition but the determination of liability does not occur until after the bar date by which a proof of claim must be timely filed. [93] Additionally, under present law a chapter 13 debtor may obtain a discharge for taxes that have been fraudulently underreported [94] or evaded more than 3 years ago. [95] Certain tax penalties can also be discharged under chapter 13, [96] although those same taxes and penalties would not be dischargeable for individuals in a chapter 7 or 11 case. [97]

Short of the IRS proposal, I proposed a modest modification to the superdischarge of chapter 13: amend 11 U.S.C. § 1328(a) to deny a discharge to those chapter 13 debtors who have filed fraudulent returns [98] or who have engaged in an affirmative act or acts in an attempt to willfully and fraudulently evade a tax [99] where the governmental unit proves

in accordance with applicable nonbankruptcy law the fraudulent conduct in the bankruptcy case. [100] Evidence suggests that taxing authorities receive a greater recovery in chapter 13 cases than they do in chapter 7 cases. [101] In fact, the Bankruptcy Code recognizes this consequence in chapter 13 cases and provides incentives for individual debtors to seek relief under chapter 13. [102] These incentives include relief from postpetition interest on priority tax claims, [103] an expanded scope of automatic stay, [104] and a broader discharge. [105] These incentives for filing under chapter 13 as opposed to chapter 7 should be continued. Thus, a broader scope of discharge is justified under chapter 13.

At the same time, however, the chapter 13 process should not result in a haven from tax liabilities for those taxpayers who have defrauded a governmental authority. Although the requirement that any chapter 13 plan must be proposed in good faith [106] may operate as a gate to prevent abuses of the bankruptcy process by tax protesters and defrauders, [107] courts are not in agreement on the meaning of good faith in these circumstances and present law lacks clarity. [108] Thus, a specific amendment to 11 U.S.C. § 1328(a) is necessary to except from the scope of the chapter 13 discharge tax claims with respect to which the debtor made a fraudulent return or with respect to which the debtor engaged in an affirmative act or acts in an effort to willfully and fraudulently attempt to evade a tax where the governmental unit proves in accordance with applicable nonbankruptcy law the fraudulent conduct in the bankruptcy case. [109]

Interestingly, four votes were cast by members of the Advisory Committee in favor of this modest proposal to limit chapter 13 discharges. [110] Even more fascinating is the fact that those representatives from the federal government voted *against* the proposal, [111] obviously embracing an all or nothing stance. Big mistake. Adding the two votes held by the federal representatives to the four would have forged a majority in favor of modest modification to the chapter 13 discharge. Some NBRC Commissioners used the lack of majority vote to support inaction on their part — again, I believe, a big political mistake.

The chapter 13 discharge is the most controversial issue for the NBRC. Who can justify expanded debt relief for a debtor who has filed fraudulent returns? Rejection by the NBRC of any modification to the chapter 13 discharge, where a debtor files fraudulent returns or willfully attempts to evade or defeat a tax, [112] will return to haunt NBRC efforts at meaningful bankruptcy reform.

III. The Ugly: Section 724(b) [113]

Another topic that generated lively debate among members of the Advisory Committee and the NBRC is the subordination of tax liens under section 724 in chapter 7 cases to certain priority claims, including the administrative expenses, priority wage claims, and priority employee plan contributions claims. [114] Ultimately, the Advisory Committee voted five to four to recommend to the NBRC the repeal of section 724(b) outright. [115] The four dissenting votes were cast by the four private bar representatives who were vigorously opposed to any modification to section 724(b). [116] In the end, the NBRC rejected the recommendation of the Advisory Committee. [117]

However, on September 4, 1997, Senator Chuck Grassley (R−Iowa) preempted the NBRC by introducing S.1149, "The Investment in Education Act of 1997." [118] One provision of the bill seeks significant changes to 11 U.S.C. § 724(b). [119]

The proposal to amend section 724(b) has been the subject of much debate because of a similar proposal adopted by the NBRC [120] as well as an outpouring of support by local tax authorities. [121] Short of an outright repeal of section 724(b), both S.1149 and the NBRC proposal would continue the effect of a partial subordination of a tax lien to certain designated priority claims, [122] but exempt from subordination "a properly perfected unavoidable tax lien arising in connection with an ad valorem tax on real or personal property of the estate." [123]

The private bar has generally sought the retention or modest modification of section 724(b). There is a long−standing policy beginning with the 1938 Chandler Act amendments that has subordinated tax liens to administrative expenses. [124] On each subsequent occasion in which Congress has revisited the issue, it has broadened the extent of such subordination. [125] If the bankruptcy system is to be viable, all administrative expenses must be paid. The Bankruptcy Code creates its own set of priorities, in which administrative expenses are generally superior to tax claims. [126] In chapter 7 cases, this fundamental structure should not be nullified because a state legislative body gives itself a tax lien that results in circumventing the system of priorities created by the federal Bankruptcy Code.

Nonetheless, the argument against partial subordination of tax liens under section 724(b) is persuasive. The section is complicated and obscure, making it difficult to understand and apply. Thus, it is applied inconsistently or not at all, creating disparate results in different districts. In fact, many trustees ignore the issue unless pressed, and some embrace the practice of not subordinating ad valorem tax liens already. Furthermore, the section imposes a hardship upon individual debtors because property that would have been used to pay nondischargeable tax debts is, instead, used to pay dischargeable accountant's and attorney's fees. Finally, the section works a particular hardship on local school districts and city/county governments that may be very dependent on the revenue at risk under section 724(b). [127]

Both the NBRC proposal and S.1149 strike a compromise position. First, both models retain much of the efficacy of present section 724(b). [128] Second, both models require a trustee to marshal unencumbered assets of the bankruptcy estate and surcharge secured claims under section 506(c) before seeking subordination under section 724(b). [129] This will make the application of the statute more complex. But here, the models diverge significantly. The NBRC proposal requires a trustee to marshal before subordinating *any* tax lien. [130] S.1149 requires a trustee to marshal before subordinating a tax lien "which has arisen by virtue of *state* law." [131] Under S.1149, it appears that federal tax liens may be subordinated without a trustee first seeking to marshal unencumbered assets of the bankruptcy estate. [132] I see no persuasive justification for this difference.

Another significant difference between the NBRC proposal and S.1149 is that S.1149 provides an exemption to the exclusion. Let us take a minute to unpack what seeks to be new section 724(f). This proposed subsection provides that, notwithstanding the exclusion of ad valorem tax liens from partial subordination, any claim for wages under section 507(a)(3) or for contributions to an employee benefit plan entitled to priority under section 507(a)(4) may be paid from property of the estate that secures "a tax lien" in accordance with section 724(b) so long as the marshaling requirements identified above have been met. [133] Thus, in some limited circumstances, the ad valorem tax lien remains susceptible to partial subordination to certain wage and employee benefit plan contributions. At one point, the Government Working Group of the NBRC entertained the wage and contribution exemption, but the exemption did not make the final cut.

Both S.1149 and the NBRC proposal seek modest modification to section 724. A bold and simple stroke is in order. I quake at the complexities and difficulties posed by both the S.1149 and NBRC proposals. However, my experience in this area has taught me that most of the complex issues posed by rewrite of section 724 will be addressed because trustees are going to continue to ignore section 724 unless a simpler and more coherent model is embraced.

IV: My Candidate for Most Controversial: Modification of I.R.C. § 1001 to Provide for Parallel Tax Treatment of Recourse and Nonrecourse Debt

The NBRC has adopted the recommendation of the Advisory Committee that Congress modify I.R.C. § 1001 to provide that tax consequences of the transfer of an asset to satisfy a nonrecourse debt, (for example, foreclosure or transfer in lieu of foreclosure) should be the same as a transfer to satisfy a recourse debt. [134]

Presently, what drives the controversy in this area of bankruptcy taxation is the disparate treatment by the Internal Revenue Code between cancellation of indebtedness ("COD") income under I.R.C. section 108 [135] and gain realized upon foreclosure under I.R.C. § 1001(c). [136] Under I.R.C. § 108, COD income that would otherwise be includable in gross income under I.R.C. § 61(a) [137] is excludable to the extent the taxpayer is insolvent or the discharge occurs pursuant to a court order in bankruptcy. [138] However, the Internal Revenue Code extracts a price for the I.R.C. § 108 exclusion: certain enumerated tax attributes must be reduced by the directives of section 108(b). [139] If there are no tax attributes or the attributes have been used up, any remaining COD income evaporates in bankruptcy, meaning the taxpayer is no longer liable for the tax associated with the income. [140] This is an important tax break for bankrupt or insolvent taxpayers, which is not provided for other taxpayers.

This tax favoritism does not exist for amounts realized under I.R.C. § 1001(c) upon a sale or exchange such as a foreclosure because the I.R.C. § 108 exclusion applies *only* to COD income and not to reduce tax liability associated with gain realized from high−debt low−basis property. [141]

What exacerbates the situation, however, is how nonrecourse debt is treated upon foreclosure. [142] If the secured debt is recourse, the IRS has maintained the position that the full tax consequences take two steps to ascertain. [143] First, the amount of cancellation of indebtedness income is equal to the difference between the fair market value of the property and the amount of the recourse debt. [144] This amount may be excluded in bankruptcy under I.R.C. section 108. [145] Second, the amount realized for I.R.C. § 1001(c) purposes is equal to the difference between the asset's fair market value and its adjusted basis. [146] This I.R.C. § 1001(c) amount is not governed by the more generous rules of exclusion in I.R.C. § 108. This two−step method asserted by the IRS often leads the parties in informal workouts or pursuant to agreed orders terminating the automatic stay in bankruptcy to agree to a value for the underlying asset on the extreme low end of the range of fair market values to minimize gain and to maximize cancellation of indebtedness income.

If the secured debt is nonrecourse, the Supreme Court mandates significantly different treatment. If the secured debt is nonrecourse, the amount realized for I.R.C. § 1001(c) purposes is equal to the difference between the face amount of the debt and the adjusted basis in the asset. [147] The fair market value of the property is irrelevant to the calculation. [148] This creates greater hardship when the assets in question have substantially declined in value as was experienced in the real estate markets in the Southwest. Furthermore, no cancellation of indebtedness income is generated by the satisfaction of nonrecourse debt by foreclosure; [149] thus, a taxpayer cannot use I.R.C. § 108 to alleviate any tax associated with the foreclosure sale and ultimate discharge of nonrecourse debt. This peculiar result has led some taxpayers to attempt to convert nonrecourse debt for which they are not personally liable to recourse debt for which they are personally liable in an attempt to use I.R.C. § 108 to minimize taxes owed from the contemplated foreclosure. [150]

An example may illuminate the disparate treatment of nonrecourse debt vis−à−vis recourse debt. Let us assume that a debtor, we shall call him Tinker, owns an office building subject to nonrecourse indebtedness of $1 million. The fair market value of the property is $500,000, and the adjusted basis is $250,000. If the lender forecloses upon the property in full satisfaction of the debt, the amount realized under I.R.C. § 1001(c) is $750,000, the difference between the amount of nonrecourse debt and the adjusted basis. In other words, Tinker is treated as though he sold the property for the face amount of the debt. None of this I.R.C.
§ 1001(c) gain may be excluded under I.R.C. § 108 because section 108 is reserved for cancellation of indebtedness income.

Let us assume that Chance operates a similar building on a property adjacent to Tinkers. In fact, she used the same lender and granted a lien in the property securing $1 million of indebtedness. She is personally liable for the debt, which is recourse as to Chance. The fair market value of the property and the adjusted basis are exactly the same as in Tinker's example, $500,000 and $250,000 respectively. If the lender foreclosures on the property in full satisfaction of the recourse debt, Chance's tax consequences are vastly different than Tinker's. Using the two−step analysis asserted by the IRS, Chance recognizes cancellation of indebtedness income of $500,000, the difference between the amount of indebtedness and the fair market value of the property. The entire amount may be excluded from income pursuant to I.R.C. § 108. Chance also recognizes income under I.R.C. § 1001(c) of $250,000, the difference between the property's fair market value and its adjusted basis. Thus, on the same facts, Chance recognizes $500,000 *less* as income than Tinker *solely* because the former's debt was recourse, and the latter's debt was nonrecourse.

The NBRC proposal provides that the difference between the basis of the property and the fair market value of the property would be a gain or loss on transfer and the difference between the fair market value and the amount of the nonrecourse debt would be income from the cancellation of debt under I.R.C.
§ 61. [151] The tax treatment of income from cancellation of debt would be governed by I.R.C. § 108. [152] This treatment is consistent with the tax consequence of the transfer of property to satisfy recourse debt.

This change would overrule *Commissioner v. Tufts* [153] and follow the position taken by Professor Wayne G. Barnett in an amicus to the *Tufts* case. It would eliminate the problems that arise when recourse debt is converted to nonrecourse debt over which the taxpayer has no control such as when the trustee abandons property to the debtor. For example, in Private Letter Ruling 8918016 (January 31, 1989), the IRS ruled that the abandonment was not a taxable event to the estate but held that the recourse debt became nonrecourse as a result of the discharge.

Taxpayers that plan to transfer property to satisfy a nonrecourse debt often work out an agreement with the creditor to forgive all or part of the debt in excess of the value of the property as a separate transaction prior to transferring the property to avoid all of the gain being taxed as a gain on transfer. (Of course, if the taxpayer has capital loss carryovers, this agreement would be unnecessary.) This proposed change to I.R.C. § 1001 would eliminate action of this nature and the problems associated with attempting to determine if debt is recourse or nonrecourse or attempting to convert nonrecourse debt to recourse or visa versa depending on the needs of the taxpayer.

V. Conclusion

The bold efforts on the part of the NBRC, working through its Chair Brady Williamson, in seeking advice and confronting the tax issues head on should be applauded. By appointing an Advisory Committee, and authorizing the Advisory Committee to undertake a comprehensive assessment of both the Bankruptcy Code and Internal Revenue Code, the NBRC received valuable input in the formation of bankruptcy tax provisions and, ultimately, a start at framing a coherent bankruptcy tax policy.

FOOTNOTES:

[*] Associate Professor, Georgia State University College of Law; Vice−Chair, Bankruptcy Taxation Committee of the American Bankruptcy Institute. Professor Williams served as Chair of the Tax Advisory Committee to the National Bankruptcy Review Commission and as its Commission Adviser/Tax Project. He believes all bankruptcy taxation issues are of biblical proportions. All comments (and errors) are his own. Thanks to my research assistant, Susan Seabury, for her assistance in the preparation of this article.Back To Text

[1] *See* Nat'l Bankr. Rev. Comm'n, Bankruptcy: The Next Twenty Years, Final Report 943 (1997) [hereinafter Commission Report]. In addition to this article, Professor Williams also prepared the comments on *Taxation and the Bankruptcy Code* for the NBRC. *See id.**Back To Text*

[2] *See id.**Back To Text*

[3] The other members of the Tax Advisory Committee to the NBRC were Paul Asofsky, Mark Browning, Steve Csontos, Bob MacKenzie, Bob Miller, Grant Newton, Joan Pilver, Mark Segal, and Ken Weil.Back To Text

[4] *See* Tax Advisory Committee to the Nat'l Bankr. Rev. Comm'n, Final Report 5−6 (1997) [hereinafter Tax Report].
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[5] *See* Commission Report, *supra* note 1, at 947.Back To Text

[6] *See id.**Back To Text*

[7] *See id.**Back To Text*

[8] *See* Title 11, U.S.C. (1994).Back To Text

[9] *See* Title 26, U.S.C. (1994).Back To Text

[10] *See* Commission Report, *supra* note 1, at 947.Back To Text

[11] *See id.**Back To Text*

[12] *See id.**Back To Text*

[13] *See id.**Back To Text*

[14] *See id.**Back To Text*

[15] *See* Commission Report, *supra* note 1, at 947; *see also* Tax Report, *supra* note 4, at 1−14 (discussing consensus items).Back To Text

[16] *See* Commission Report, *supra* note 1, at 947−48.Back To Text

[17] *See id.* at 948. *See also* Tax Report, *supra* note 4, at 14−16 (discussing those items that would have been consensus items but for federal participants abstention).Back To Text

[18] *See* Commission Report, *supra* note 1, at 948. *See also* Tax Report, *supra* note 4, at 16−51 (discussing those items Advisory Committee deemed very important and very controversial to controversial). Back To Text

[19] *See* Tax Report, *supra* note 4, at 16−51 (advising NBRC on items considered very important to highly controversial).Back To Text

[20] *See* Commission Report, *supra* note 1, at 948 (discussing work done on bankruptcy taxation issues prior to formation of Advisory Committee).*Back To Text*

[21] *See id. See also* Dep't of Justice, The Report of the Department of Justice Working Group, 752 PLI/Comm 11 (Apr. 1997).Back To Text

[22] *See* Commission Report, *supra* note 1, at 948.Back To Text

[23] *See id.Back To Text*

[24] *See id.Back To Text*

[25] *See id. See also* Nat'l Bankr. Rev. Comm'n, Government Working Group Proposal #2: Section 724(b) (1997) [hereinafter Working Group Proposal] (discussing three alternative amendments of section 724(b)).Back To Text

[26] *See* Commission Report, *supra* note 1, at 948.Back To Text

[27] *See id.Back To Text*

[28] *See id.Back To Text*

[29] *See id.* Rather than initiate a new numbering system to track bankruptcy tax proposals, the Advisory Committee continued the numbering and tracking system of the previous tax matrices as a matter of convenience and in an effort to reduce confusion over discussions concerning bankruptcy tax proposals. Those proposals added to the matrix by the Advisory Committee were assigned 700−series index numbers. Furthermore, where appropriate, the Advisory Committee split multiple proposals into component parts; thus, original proposal No. 414 has been redesignated Nos. 414, 414(a), and 414(b). *See id.* at 948 n.2413. *See also* Tax Report, *supra* note 4, at 4.Back To Text

[30] *See* Commission Report, *supra* note 1, at 949.Back To Text

[31] *See id.* at 960−964 (adopting Advisory Committee's recommendation to require debtor file all tax returns within six years prior to petition date as prerequisite to confirming chapter 13 plan).Back To Text

[32] *See id.* at 945, 960−64.Back To Text

[33] *See id.* at 960. *See generally* I.R.C. § 6001 (1994) (requiring all liable for any tax imposed by Internal Revenue Code file returns and comply with Internal Revenue Code rules and regulations).Back To Text

[34] *See* Commission Report, *supra* note 1, at 962. In response to concerns expressed by debtor and trustee representatives at the NBRC sessions in Sante Fe and San Diego, that requiring an unlimited number of returns to be

filed would discourage bankruptcy non−filers from "reentering the system," tax authority representatives indicated a willingness to compromise on a limited number of years if return filing was made an absolute prerequisite for confirmation and thus, indirectly, discharge. *See id.* Six years was generally agreed to be a reasonable period for requiring returns to be filed. *See id.* Back To Text

[35] *See* Commission Report, *supra* note 1, at 961 (requiring debtor properly file prepetition tax returns at least one day prior to first creditors' meeting). *See also* 11 U.S.C. § 341 (1994). Section 341 provides that the trustee shall convene and preside at a creditors' meeting within a reasonable time after an order for relief has been filed. *See* id.*; see also* 3 Collier on Bankruptcy ¶ 341.01, at 3 (Lawrence P. King et al. eds., 15th ed. rev. 1997). At this time the debtor will submit to an examination under oath by "[c]reditors, any indenture trustee, any trustee or examiner in the case, or the United States trustee." 11 U.S.C. § 343. The courts have been split on the issue of the when the debtor is required to file prepetition tax returns. In *In re Hahn*, the court gave the debtor thirty days to file after filing a chapter 13 petition. *See* In re Hahn, 200 B.R. 249, 250 (Bankr. M.D. Fla. 1996). However, in *In re Anderson*, the court required that the IRS file a motion to compel the debtor to file tax returns. *See* Anderson v. United States (In re Anderson), 165 B.R. 445, 446 (S.D. Ind. 1994). Further, in *In re Bradford*, the court did not believe it had the authority to require the debtor to file tax returns. *See* In re Bradford, 1994 WL 680987 (Bankr. E.D. Va. 1994).Back To Text

[36] *See* Commission Report, *supra* note 1, at 961. Failure to file a tax return before filing a chapter 13 petition has been construed by the courts as bad faith on the part of the debtor and is grounds for dismissal. *See* In re Tobias, 200 B.R. 412, 415 (Bankr. M.D. Fla. 1996) (finding debtor's disregard of court's order, as well as failure to file tax returns, evidenced lack of good faith in bankruptcy filing) (citing In re Crayton, 169 B.R. 243, 245 (Bankr. S.D. Ga. 1994).Back To Text

[37] *See* Commission Report, *supra* note 1, at 961. Among the trustee's other duties, the trustee must investigate the financial affairs of the debtor. *See* 11 U.S.C. § 704 (1994).Back To Text

[38] *See* Commission Report, supra note 1, at 962 (allowing categorical answer to trustee's question of whether plan provides for payment of taxes reflected in returns).Back To Text

[39] *See* id. Chapter 13 requires that the debtor's plan provide for full repayment in deferred cash payments of all claims entitled to priority under section 507. *See* 11 U.S.C. § 1322 (1994). Therefore, the prepetition returns must match up with the payment schedule in the plan. *See* id.Back To Text

[40] *See* Commission Report, supra note 1, at 961. The NBRC Recommendation allows the trustee discretion to give the debtor a limited extension of time to file returns where the trustee is satisfied the debtor is making a reasonable effort to get returns prepared. *See* id. at 962. The trustee must ensure the debtor will perform his intention as specified in section 521(2)(B) of the Bankruptcy Code. See 11 U.S.C. § 704(3) (1994). In appropriate circumstances, this recommendation will give the debtor additional time to accomplish this task by extending the time the debtor has to file the necessary financial documents. *See* Commission Report, supra note 1, at 961.Back To Text

[41] *See* Commission Report, supra note 1, at 961. This additional time would be granted via an interim order directing the debtor to file returns within these specified times. *See* Ronald W. Goss, Meetings of Creditors Under Section 341 of the Bankruptcy Code: A Primer, 17 J. Contemp. L. 1, 40 (1991) (discussing importance of creditors' committee and function of interim order).Back To Text

[42] *See* Commission Report, *supra* note 1, at 962.Back To Text

[43] *See* Commission Report, *supra* note 1, at 961−62 (allowing trustee to ask debtor for copies of filed returns or other proof of filing to ensure debtor has filed necessary returns).Back To Text

[44] *See* id.Back To Text

[45] *See* id.*; see also* 11 U.S.C. § 1307(c) (1994) (providing party in interest or trustee may request conversion or dismissal of chapter 13 in certain circumstances).Back To Text

[46] *See* Commission Report, supra note 1, at 961. *See also* 11 U.S.C. § 1307(c) (1994) (listing events that may cause court to convert or dismiss chapter 13 bankruptcy case).Back To Text

[47] *See* Commission Report, supra note 1, at 963. *See, e.g.*, In re Koval, 205 B.R. 72, 76 (Bankr. N.D. Tex. 1996) (finding cause to dismiss under section 1307 for failure to file post−petition federal tax returns); In re Tobias, 200 B.R. 412, 415 (Bankr. M.D. Fla. 1996) (treating failure to file tax return as evidence of lack of good faith, thus, warranting dismissal) (citing *In re* Crayton, 169 B.R. 243, 245 (Bankr. S.D. Ga. 1994)).Back To Text

[48] *See* Commission Report, *supra* note 1, at 963.Back To Text

[49] *See* Commission Report, *supra* note 1, at 961−63 (allowing possibility of extension of filing deadline for good cause shown).Back To Text

[50] *See* id. (providing automatic dismissal is result for failure to meet extended deadline).Back To Text

[51] *See id.* at 963. Back To Text

[52] *See* id.Back To Text

[53] *See id.* at 961, 963.Back To Text

[54] *See* Commission Report, *supra* note 1, at 961−63. *See* 11 U.S.C. § 1325 (1994) (listing requirements for confirmation of chapter 13 plan).Back To Text

[55] *See* Commission Report, supra note 1, at 963 (describing problems created by current system for debtors and creditors).Back To Text

[56] *See* id. (exploring proposal's rational).Back To Text

[57] *See* id. at 963 (considering problems inherent in issue from tax authorities' perspective).Back To Text

[58] *See* id. at 961−62 (allowing trustee to ask debtor for copies of filed returns or other proof of filing in ensuring debtor has filed necessary returns).Back To Text

[59] For the requirements of chapter 13 confirmation, see 11 U.S.C. § 1325 (1994).Back To Text

[60] *See* Commission Report, supra note 1, at 963 (posing legal and practical questions raised by practice of confirming chapter 13 plans before amount of priority tax debt is known and concluding these issues would be eliminated under NBRC recommendation).Back To Text

[61] *See* id. (explaining proposed treatment of delinquent debtors).Back To Text

[62] *See* id. (explaining proposed treatment of non−delinquent debtors).Back To Text

[63] *See* id. at 963−64 (justifying disparate treatment of delinquent versus non−delinquent filers).Back To Text

[64] *See* id. at 964.Back To Text

[65] *See* Commission Report, supra note 1, at 964.Back To Text

[66] *See* id. at 961; *see also* 11 U.S.C. § 502(b) (1994) (specifying result of objection to proof of claim).Back To Text

[67] *See* Commission Report, supra note 1, at 961 (proposing to change governmental bar date in certain cases); *see also* 11 U.S.C. § 502(b)(6) (1994) (setting deadlines after which proofs of claim may not be filed).Back To Text

[68] *See* Commission Report, supra note 1, at 964.Back To Text

[69] *See* id.Back To Text

[70] *See* id.Back To Text

[71] *See* id.Back To Text

[72] *See, e.g.*, In re Shabazz, 206 B.R. 116, 124 (Bankr. E.D. Va. 1996) (characterizing estimated claims for tax debts as proper); In re King, 102 B.R. 184, 187 (Bankr. D. Neb. 1989) (stating that IRS can assert estimate as claim), rev'd on other grounds, 137 B.R. 43 (D. Neb. 1991).Back To Text

[73] *See* Commission Report, supra note 1, at 964.Back To Text

[74] *See* id.Back To Text

[75] *See* id. (stating results of tax authority estimating claims).Back To Text

[76] *See* id. This requirement would not prevent debtors from objecting to audit claims covering periods for which returns have been filed. *See* id. Back To Text

[77] *See* Commission Report, supra note 1, at 964. "Filing of returns" presumes returns are *properly* filed —i.e., with the right agency, at the right address, with the right tax identification numbers, with the requisite signatures, and subject to penalties of perjury/false filing. *See* id. If not taken up in the context of discussion on "notice rules," such presumptions may need to be added to this proposal. *See* id. "Returns" for purposes of this section would include substitutes for return that the debtor has signed and nonbankruptcy tax tribunal stipulations of liability. *See* id.Back To Text

[78] *See* Tax Report, *supra* note 4, at 20−22. The Advisory Committee proposed three alternative recommendations to the NBRC: (1) retain the current chapter 13; (2) conform chapter 13 discharge to that of chapter 7; and (3) modify chapter 13 discharge. *See* id. *See also* 11 U.S.C. § 1325 (1994) (listing requirements for confirmation of chapter 13 plan). Back To Text

[79] *See generally* David G. Epstein et al., Bankruptcy § 9−20 (1993) (discussing scope of chapter 13 discharge). Back To Text

[80] *See* 11 U.S.C. § 1325 (a)(4) (1994) (requiring amount paid on each claim be greater than it would be under chapter 7).Back To Text

[81] *See* Epstein, supra note 79, §§ 9−14, 9−20 (discussing good faith and purpose of chapter 13 discharge).Back To Text

[82] *See* 11 U.S.C. § 1325(a)(3) (requiring chapter 13 plan be proposed in good faith). Back To Text

[83] *See* 11 U.S.C. § 1325(a)(4) (requiring, as of effective date, unsecured creditors receive value equal to that they would have received under chapter 7 plan). Back To Text

[84] *See* Tax Report, supra note 4, at 20 (considering I.R.S. proposal to conform discharge of chapter 13 to that of chapter 7). Back To Text

[85] *See* id.Back To Text

[86] *See* id. Back To Text

[87] *See* id*; see also* 11 U.S.C. § 1328(a) (1994) (discharging debts that are provided for in chapter 13 plan after full payment under plan has been made).Back To Text

[88] *See* Tax Report, supra note 4, at 20. *See, e.g.*, In re Ryan, 78 B.R. 175, 178 (Bankr. E.D. Tenn. 1987) (stating that creditor's failure to timely file proof of claim resulting in unpaid debt will not prevent discharge, which requires only that debt be in plan and that plan be completed); In re Goodwin, 58 B.R. 75, 77 (Bankr. D. Me. 1986) (stating failure to file proof of claim results in discharge of any claim in plan). Back To Text

[89] *See* 11 U.S.C. § 523(a)(1) (providing no discharge of taxes for an individual debtor under chapter 7); *see also* 11 U.S.C. § 727.Back To Text

[90] *See* 11 U.S.C. § 328(a) (providing that discharge upon completion of chapter 13 plan discharges all debts provided for in the plan).Back To Text

[91] *See, e.g.*, Ledlin v. United States (In re Tomlan), 102 B.R. 790, 797 (E.D. Wash. 1989) (ruling untimely IRS filing of proof of claim five days after deadline); Goodwin, 58 B.R. at 77 (disallowing IRS claim on ground that there was failure to file within specified time requirements).Back To Text

[92] *See, e.g.*, Ryan, 78 B.R. at 178 (holding debt may be discharged regardless of failure to pay in accordance with plan due to IRS' failure to file proof of claim); Leber v. Illinois Department of Revenue (In re Leber), 134 B.R. 911, 915 (Bankr. N.D. Ill. 1991) (holding debt may be discharged due to Illinois Department of Revenue's failure to file proof of claim); Border v. Internal Revenue Service (In re Border), 116 B.R. 588, 591−95 (Bankr. S.D. Ohio 1990) (holding I.R.S. prepetition tax claim loses priority status and may be discharged where I.R.S. failed to file proof of claim).Back To Text

[93] *See* 11 U.S.C. § 502(i) (1994) (providing claim arising after commencement of case is determined as if each claim had arisen before filing date). *See also* In re Hotel Nevada Corp., 75 B.R. 174, 176 (Bankr. D. Nev. 1987) (discussing situation where tax liability is incurred pre−petition but not assessed until after filing of petition). Back To Text

[94] *See* In re Little, 116 B.R. 615, 620 (Bankr. S.D. Ohio 1990) (stating chapter 13 superdischarge allows discharge of fraudulently obtained debt where debtor repays obligation over time). *See also* Johnson v. Edinboro State College, 728 F.2d 163, 166 n. 4 (3d Cir. 1984) (noting that fraudulently obtained debts may still be discharged under chapter 13).Back To Text

[95] *See* 11 U.S.C. § 507(a)(8)(D) (allowing discharge of debts evaded "after three years before the date of the filing of the petition"); s*ee also* Smith v. United States, 202 B.R. 277, 280 (S.D. Ind. 1996) (finding section 523 discharge exception where chapter 7 debtor's attempted to evade taxes through excessive exemptions). Back To Text

[96] *See* 11 U.S.C. § 1328(a) (allowing discharge of taxes that are provided for in plan).Back To Text

[97] *See* id. § 523(a)(1) and (7) (disallowing discharge of certain tax penalties dischargeable under section 1328). Back To Text

[98] *See* id. § 523(a)(1)(B). Back To Text

[99] *See* id. § 523(a)(1)(C). Back To Text

[100] *See* Tax Report, supra note 4, at 20−21 (proposing modest modification of chapter 13 superdischarge).Back To Text

[101] *See* id.Back To Text

[102] *See, e.g.*, 11 U.S.C. §§ 1328(a), 1325. Back To Text

[103] *See generally* Jack F. Williams, Canning the Chapter 13 Super Discharge, 4 Am. bankr. inst. l. rev. 553, 553−54 (1996). Back To Text

[104] *See* 11 U.S.C. § 1301. Back To Text

[105] *See* id. § 1328(a). Back To Text

[106] *See* id. § 1325(a)(3).Back To Text

[107] *See* id. § 1328(a)(3); *see also* Williams, supra note 103, at 553−54. Back To Text

[108] *See* Epstein, supra note 79, at § 9−20. Back To Text

[109] *See* Tax Report, supra note 4, at 21.Back To Text

[110] *See* id.Back To Text

[111] *See* id.Back To Text

[112] *See* Tax Report, supra note 4, at 48 (proposing that section 523(a)(1)(C) exception "[require] a showing by a taxing authority in the bankruptcy case of an affirmative act or acts of misconduct and a state of mind requirement"). Back To Text

[113] *See* 11 U.S.C. § 724(b) (1994).Back To Text

[114] *See* Tax Report, supra note 4, at 16−17 (discussing proposal to "retain present 11 U.S.C. § 724(b), which requires subordination of tax liens to administrative expenses and priority claims in a chapter 7 case").Back To Text

[115] *See* id. at 17 (recommending repeal of present section 724(b)).Back To Text

[116] *See* id.Back To Text

[117] *See* Commission Report, supra note 1, at 803−11. Section 3.2.4 of the Commission Report, entitled "Ad Valorem Tax Priority under 11 U.S.C. § 724(b)" proposed:

> 11 U.S.C. § 724(b) should be amended to exempt from subordination properly perfected, nonavoidable liens on real or personal property of the estate arising in connection with an ad valorem tax. Section 724(b) should also require the trustee to marshall unencumbered assets of the bankruptcy estate and surcharge secured claims, if warranted by the circumstances, under section 506(c) prior to subordinating any tax liens under the statute.

Id. Back To Text

[118] *See* S. 1149, 105th Cong. (1997) (seeking to amend Bankruptcy Code "to provide for increased education funding, and for other purposes.").Back To Text

[119] *See* S. 1149 at § 2 (seeking to change treatment of certain liens under section 724(b)).Back To Text

[120] *See* Commission Report, supra note 1, at 803.Back To Text

[121] *See* Cong. Rec. S. 1149 at 8828−8831 (daily ed. Sept. 4, 1997) (regarding letters from local tax authorities and school boards, seeking modifications of section 724(b) sent to Senator Charles E. Grassley, Chairman of U.S. Senate Committee on the Judiciary, Subcommittee on Administrative Oversight and the Courts). Back To Text

[122] Section 724(b) allows priority to a "holder of a claim of a kind specified in sections 507(a)(1), 507 (a)(2), 507 (a)(3), 507(a)(4), 507(a)(5), 507(a)(6), or 507(a)(7) of this title to the extent of the amount of such allowed tax claim that is secured by such tax lien . . . ." 11 U.S.C. § 724(b). Back To Text

[123] S. 1149 at § 2(a)(1) (1997); Commission Report, supra note 1, at 37.Back To Text

[124] *See* H.R. Rep. No. 95−595, at 382 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6338 (indicating section 724(b) was derived from section 67c(3) of the Chandler Act "without substantial modification").Back To Text

[125] *See* Commission Report, supra note 1, at 807 n.1988. "The substantial expansion of the categories of priority claims since the inception of our bankruptcy laws has, over the years, led to a continued erosion of the second position of taxing authorities." Id.Back To Text

[126] *See* 11 U.S.C. § 724(b)(2) (1994). *See generally* C. Richard McQueen & Jack F. Williams, Tax Aspects of Bankruptcy Law & Practice, § 9:39 (3d ed. 1997) (providing examples of application of section 724(b)).Back To Text

[127] *See* Commission Report, supra note 1, at 808 (noting application of section 724(b) may undermine ability of state and local governments to generate tax revenue and thereby finance "essential public services").Back To Text

[128] *See generally* S. 1149, 105th Cong. at § 2 (1997); Commission Report, supra note 1, at 943.Back To Text

[129] *See* S. 1149 at § 2(e); Commission Report, supra note 1, at 37 (requiring trustee marshal unencumbered estate assets prior to subordination).Back To Text

[130] *See* Commission Report, supra note 1, at 808 (requiring trustee marshall unencumbered assets prior to subordinating any lien).Back To Text

[131] *See* S. 1149 at § 2(e). Back To Text

[132] *See* Commission Report, supra note 1, at 809.Back To Text

[133] *See* S. 1149 at § 2(f).Back To Text

[134] *See* Commission Report, supra note 1, 968−69 (proposing modification of I.R.C. § 1001 to provide for parallel treatment of recourse and nonrecourse debt). *See also* Tax Report, supra note 4, at 16 (proposing NBRC modification of I.R.C. § 1001 to provide for parallel treatment of recourse and nonrecourse debt).Back To Text

[135] *See* I.R.C. § 108 (governing tax treatment of income from cancellation of indebtedness).Back To Text

[136] *See* I.R.C. § 1001(c) (providing all gain or loss on sale or exchange of property must be recognized).Back To Text

[137] *See* I.R.C. § 108(a)(1)(A) − (B) (providing taxpayer need not recognize income from discharge of indebtedness in bankruptcy proceedings brought under chapter 11 or when taxpayer is insolvent outside bankruptcy). *See also* Treas. Reg. § 1.1001−2(a)(2) (1980) (providing amount realized on sale or exchange of property encumbered by recourse liability does not include income from discharge of indebtedness under section 61(a)(12)).Back To Text

[138] *See* I.R.C. § 108(a).Back To Text

[139] *See* I.R.C. § 108(b) (reducing tax attributes by amount excluded from gross income under section 108(a)); I.R.C. § 1017 (reducing basis of property by amount excluded from gross income under section 108).Back To Text

[140] *See* I.R.C. § 108(b)(2)(A)−(F) (providing limited number of tax attributes that must be reduced by excluded gross income; therefore, where excluded gross income exceeds maximum value of tax attributes under section 108(b)(2)(A)−(F), excess excluded gross income evaporates in bankruptcy discharge).Back To Text

[141] *See* I.R.C. § 108(e)(1) (providing that, outside of section 108(a), there is no other insolvency exception to general rule that income from discharge of indebtedness must be included in gross income).Back To Text

[142] For a detailed treatment of the tax consequences of foreclosure, see Alice Cunnigham, *Payment of Debt with Property − The Two Step Analysis after* Commissioner v. Tufts, 38 Tax Law. 575, 599 (1985) and Richard C. Onsager & John R. Becker, The Federal Income Tax Consequences of Foreclosure and Repossessions, 18 J. Real Est. Tax'n 291, 303 (1991).Back To Text

[143] *See* infra notes 144−46 and accompanying text.Back To Text

[144] *See* Treas. Reg. § 1.1001−2(e) example 8; Rev. Rul. 90−16, 1990−1 C.B. 12.Back To Text

[145] *See* 11 U.S.C. § 108(a) (1994). *See also* Albert J. Cardinali & David C. Miller, Tax Aspects of Non−Corporate Single Asset Bankruptcies and Workouts, 1 Am. Bankr. Inst. L. Rev. 87, 99−100 (1993) (discussing beneficial aspect of section 108 in allowing chapter 11 debtor or insolvent debtor outside bankruptcy to realize COD income in amount not exceeding amount of debtor's insolvency).Back To Text

[146] *See* Treas. Reg. § 1.101−2(a)(1) − (2) (as amended in 1980); Rev. Rul. 90−16, 1900−1 C.B. 12.Back To Text

[147] *See* Commissioner v. Tufts, 461 U.S. 300, 307−10 (1983) (holding that amount of nonrecourse loan assumed by purchaser is gain realized by seller).Back To Text

[148] *See* Tufts, 461 U.S. at 317.Back To Text

[149] *See* Crane v. Commissioner, 331 U.S. 1, 14 (1947) (holding amount realized for tax purposes from sale of property to buyer who assumes nonrecourse mortgage includes amount of mortgage debt assumed plus amount paid by buyer); Tufts, 461 U.S. at 307−10 (providing *Crane* holding applies even where unpaid amount of non−recourse mortgage exceeds value or property transferred); Cardinali & Miller, supra note 149, at 99−100.Back To Text

[150] *But see* I.R.C. § 269 (preventing conversion from nonrecourse to recourse when used as vehicle in tax avoidance scheme).Back To Text

[151] *See* Commission Report, supra note 1, at 968−69 (proposing modification of I.R.C. § 1001 to provide for parallel treatment of recourse and nonrecourse debt).Back To Text

[152] *See* id.Back To Text

[153] 461 U.S. 300 (1983).Back To Text