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EXPANDING THE TAX ATTRIBUTES SUCCEEDED BY BANKRUPTCY ESTATE: A PROPOSAL TO THE IRS TO ISSUE ADDITIONAL REGULATIONS UNDER IRC SECTION 1398(g)

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EXECUTIVE SUMMARY

When a debtor files for bankruptcy, a bankruptcy estate is created and generally succeeded to all the debtor's legal and equitable properties interest. However, the tax code only allows the estate to succeed to a limited number of “tax attributes” which exist as of the first day of the debtor’s taxable year when the bankruptcy commences.

IRC Section 1398(g) enumerates seven specific tax attributes that pass to the estate from the debtor, and IRC Section 1398(g)(8) allows for other tax attributes to the extent provided in regulations prescribed by the IRS. The courts have generally not allowed non-enumerated tax attributes to be used by the bankruptcy estate. Tax attributes that do not pass to the bankruptcy estate generally remain with the debtor outside of the bankruptcy.

Since IRC Section 1398 enactment in 1980, the IRS has only issued three regulations expanding this code provision. Treas. Reg. §§ 1.1398-1 & -2, promulgated in 1994, pertain to passive activity losses, passive activity credits, and “at risk” losses. Treas. Reg. § 1.1398-3, promulgated in 2002 after years of litigation, permits the succession of IRC Section 121 exclusion of gain from the sale of the debtor’s primary residence.

Without further regulations, bankruptcy estates must try to fit a non-enumerated tax attribute peg into one of the existing statutory holes. If the attempt fails, the estate will incur additional tax liabilities, thereby reducing the available funds for distribution to creditors and allowing the debtor to retain the tax attribute outside of the bankruptcy to their own benefit.

This paper proposes that the IRS issue additional IRC Section 1398(g) regulations to update the archaic statute with up-to-date regulations that account for tax attributes that properly belong to the bankruptcy estate but did not exist at IRC Section 1398’s enactment. These tax attributes should be made available to the bankruptcy estate to ensure the equitable distribution of funds to creditors and debtors.

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DISCUSSION

I. INTRODUCTION

The Internal Revenue Code ("IRC") and the Bankruptcy Code, like oil and water, do not mix well, creating uncertainty for practitioners. Among a panoply of issues arising when the two Codes intersect, issues arising under IRC Section 1398(g) stand at the forefront. This section provides a starting point to determine who, between the debtor and the bankruptcy estate, owns the debtor's tax attributes after an individual debtor files for Chapter 7 or Chapter 11 bankruptcy.

These issues stem from the fact that the IRC is not primarily concerned with fairness, equity, or a fresh start for the debtor.[4] On the other hand, the Bankruptcy Code has to balance the interest of the general creditors, the debtor, and the tax collector.[5]

IRC Section 1398(g) enumerates seven specific tax attributes that the bankruptcy estate will succeed to, and Section 1398(g)(8) provides that the IRS can expand the list of tax attributes passing to the bankruptcy estate from the debtor by issuing regulations. Since the term of IRC Section 1398(g) are sufficiently clear, the courts have generally not allowed non-enumerated tax attributes outside of IRC Section 1398(g) and the regulations to be used by the bankruptcy estate. The IRS should issue additional regulations expanding the reach of IRC Section 1398(g) to allow additional tax attributes that did not exist when IRC Section 1398(g) was enacted to pass to the bankruptcy estate. Issuing additional regulations under IRC Section 1398(g) will provide clarity and properly balance the interest of the parties in a bankruptcy proceeding.

Part II of this proposal discusses the current law. Part III highlights the historical context and litigation efforts that led to the enactment of the existing regulations and the problems that exist without the Treasury's promulgation of further regulations. Part IV discusses why specific non-enumerated attributes should belong to the bankruptcy estate. Part V contains this paper's conclusion.

II. CURRENT LAW AND THE PROBLEM ADDRESSED

As part of the Bankruptcy Tax Act of 1980, Congress enacted IRC Section 1398(g) to provide that the bankruptcy estate is a successor of certain tax attributes of the debtor, and this

[4] *E.g.*, *In re Olson*, 121 B.R. 346 (Bankr. N.D. Iowa 1990); *In re McGowen*, 95 B.R. 104 (N.D. Iowa 1988); *In re Nevin*, 135 B.R. 652 (Bankr. D. Hawaii 1991).

[5] S. Rep. No. 95-989, at 13-14 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5799-5800.

Code section authorized the IRS to promulgate regulations enumerating additional tax attributes of the debtor that will pass to the bankruptcy estate. Upon filing a bankruptcy petition, the taxpayer/debtor typically retains their tax attributes unless IRC Section 1398 and the related regulations call for the bankruptcy estate to succeed to the tax attributes. The current version of IRC Section 1398(g) allows the succession of seven specific tax attributes and three other attributes as permitted by the existing regulations:

1. Net Operating Loss Carryovers ("NOL")
2. Charitable Contributions Carryovers
3. Recovery of Tax Benefit Items
4. Credit Carryovers
5. Capital Loss Carryovers
6. Basis, Holding Period, and Character of Assets
7. Method of Accounting
8. Other Attributes Provided in Regulations Promulgated by the IRS

Since the enactment of IRC Section 1398 in 1980, the IRS has only promulgated three regulations expanding the scope of the debtor's tax attributes to which the bankruptcy estate succeeds under IRC Section 1398: Treas. Reg. §§ 1.1398-1 and 1.1398-2, promulgated in 1994, provide that the bankruptcy estate succeeds to the debtor's passive activity losses, passive activity credits, and at-risk losses; and Treas. Reg. § 1.1398-3, promulgated in 2002 after years of litigation, provides that the bankruptcy estate succeeds to the debtor's IRC Section 121 exclusion of gain from the sale of the debtor's primary residence.

Without additional regulations, bankruptcy estate must try to fit non-enumerated tax attribute pegs into one of the existing statutory holes. If such an attempt fails, the estate will incur additional tax, thereby depleting the available funds for distribution to creditors. The uncertainty of whether an estate can succeed to a tax attribute can cause multiple inefficiencies: bankruptcy creditors might pressure the estate to abandon certain assets because the estate may be taxed more on the sale of those assets without the appropriate tax attribute passing through from the debtor to the estate; the debtor might argue that the tax attribute does not belong to the estate to the debtor's benefit as the debtor can retain the attribute; a creditor might seek to have an asset remain with the debtor so they can collect on it outside of the bankruptcy proceeding; or

the taxing agency might litigate to prevent an estate from receiving the tax credits or deductions so the agency can collect more tax.

III. LITIGATION OF SECTION 1398(G) AND THE PROMULGATION OF THE TREASURY REGULATION

A. Passive Activity Losses and At-Risk Losses

Passive activity losses under IRC Section 469 did not exist at the time IRC Section 1398(g) was enacted. As a result, a debtor who filed for bankruptcy was able to successfully argue that since IRC Section 1398(g) contains an exhaustive list of tax attributes, and IRC Section 469 passive activity losses credit was different from an NOL by virtue of it being a deduction against the business that generated the loss, the debtor retained the full amount of loss outside of the bankruptcy proceeding for his own benefit. *E.g.*, *In re Rueter*, 158 B.R. 163 (N.D. Cal. 1993); *also In re Antonelli*, 150 B.R. 364 (Bankr. D. Md. 1992).

Seeing the double benefit where the debtor received the fresh start benefit of the bankruptcy proceeding but also retained the tax attributes that effectively negated future taxable income, the IRS proposed and finalized the first two regulations under IRC Section 1398(g) in 1994.

B. Section 121 Exclusion

The trustee in *In re St. Francis* sold the debtor's residence for $928,000.[6] Because the title was jointly owned with the debtor's wife, the estate's one-half interest, $464,000, after costs, expenses, and payments of liens, was $168,000.[7] Because the adjusted basis of the residence was $175,158, the estate faced a tax liability of $265,309 from the capital gains owed on the sale of the property.[8] Without the section 121 exclusion, the estate would owe $42,906 in tax, so the rational decision by the estate would have been to abandon the residence allowing the debtor to retain the possession of the residence outside of the bankruptcy proceeding.

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[6] *In re St. Francis*, 232 B.R. 518, 519 (Bankr. N.D. Ga. 1999).
[7] *Id.*
[8] *Id.*

Prior to 1997, IRC Section 121 allowed a one-time exclusion of capital gains upon the sale of a principal residence. Courts noted that the purpose of IRC Section 121 was to provide tax relief to individuals over age 55 and promote savings for retirement years and that, because IRC Section 121 provided a one-time-only exclusion, allowing the use of the exclusion by a Chapter 7 Trustee would deprive the taxpayer/debtor of the exclusion in the future in connection with the sale of post-bankruptcy acquired property.[9]

In 1997, Congress amended IRC Section 121 and eliminated several significant requirements for excluding capital gains from the sale of a primary residence. The age limitation was removed, and the one-time limitation was changed to once every two years.[10] The legislative history shows that the purpose of the 1997 amendment to IRC Section 121 was to remove the burdensome record-keeping requirements, to erase the incentive to purchase a more expensive home, which promotes inefficient use of a taxpayer's financial resources, to eliminate the disincentive to selling a home which no longer suits an individual's needs because they have already used the one-time exclusion, and to eliminate the tax traps in IRC Section 121 for couples and persons who move from a high-housing cost area to a low-housing cost area.[11] Although not explicitly stated in the legislative history, the removal of the age requirement removes the earlier focus of IRC Section 121 on tax relief and incentives specifically designed only for retirement-aged taxpayers.

After the amendment of IRC Section 121 in 1997, the IRS continued to advocate that IRC Section 121 was only available to individual debtors and not bankruptcy estates because "character" under IRC Section 1398(g)(6) should only be construed narrowly to mean long-term or short-term capital assets. Most courts disagreed, stating that "character" was not defined in the IRC and that, given its ordinary meaning, "character" would include an asset's use as a principal residence. Moreover, courts read IRC Section 1398(g)(6) together with Sections 1398(c)(1) and 1398(f)(1), which provide that the estate's tax liability should be calculated no differently than the individual debtor. Accordingly, most courts sided with the estate trustee to allow the estate's use of the IRC Section 121 exclusion, and the trustee in *In re St. Francis* was able to exclude a large portion of the gain to the benefit of the creditors.

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[9] *In re St. Francis*, 232 B.R. 518, 520 (Bankr. N.D. Ga. 1999).
[10] Taxpayer Relief Act of 1997, Pub. L. 105-34, title III, §312(a).
[11] H.R. Rep. 105-148, 105th Cong., 1st Sess. 1997 (1997 WL 353016).

In 1999, the IRS finally conceded that the IRC Section 121 exclusion belonged to the bankruptcy estate, after losing on this issue in at least eight cases. The IRS issued the Change in Litigation Chief Counsel Notice to IRS attorneys to no longer assert that the bankruptcy estate could not utilize IRC Section 121 where the facts demonstrate that the debtor met the requirements found in IRC Section 121.[12] Subsequently, in 2001, the IRS issued a proposed regulation providing that the bankruptcy estate succeeds to the debtor's IRC Section 121 exclusion. The IRS held hearings and published the final version of Regulation § 1.1398-3 on December 24, 2002.[13]

C. The Issues Presented

Courts have disallowed tax attributes in litigation because the IRC Section 1398 language is sufficiently clear, and the courts were not empowered to rewrite the Internal Revenue Code to permit the estate to succeed to non-enumerated tax attributes.[14] These highlight the need for the IRS to issue additional regulations under IRC Section 1398 dealing with new tax attributes that did not exist at the time of enactment, as was the case of the passive activity loss. The problem is not with the limitation of which tax attributes the estate should succeed to but rather the IRS's failure to issue additional regulations.

IV. NON-ENUMERATED TAX ATTRIBUTES THAT PROPERLY BELONG TO THE BANKRUPTCY ESTATE

A. Percentage Depletion Carryovers IRC Section 613A(d)

Owner-lessors and operator-lessees of oil and gas interests can claim depletion associated with oil and gas production. This deduction is based on the depletion of the mineral resource, similar to how depreciation is based on the wear and tear of assets used in the taxpayer's trade or business.

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[12] Chief Counsel Notice (35)000- 162 (August 10, 1999).

[13] https://www.federalregister.gov/documents/2002/12/24/02-32281/exclusion-of-gain-from-sale-or-exchange-of-a-principal-residence

[14] *See*, *In re Rueter* 158 B.R. 163, 167 (N.D. Ca. 1993)(the court declined to jump the regulatory gun giving the bankruptcy estate the benefit of passive activity losses credit despite the IRS had proposed but not yet adopted the regulation); *In re Barden*, 205 B.R. 451, 455 (E.D.N.Y. 1996), *aff'd per curiam*, 105 F.3d 821 (2d Cir. 1997).

A taxpayer can take the depletion deduction in the greater of the amount calculated under the cost depletion method or the percentage depletion method.[15] The cost depletion method is available where the landowner knows explicitly the basis allocated to the mineral portion. However, most landowners do not allocate any part of the property's basis to oil and gas reserves, so that percentage depletion may be the only depletion method available.

Under the percentage depletion method, the taxpayer (owner-lessor or a producer that is not a retailer or refiner) uses a percentage of gross income from the property, which is limited to the lesser of the following:

- 15% of the gross income from the oil/gas property; or
- 65% of the taxable income from all sources.[16]

Any amount not deductible due to the 65% limitation can be carried over to the following year, subject to the same restrictions.[17] Any amount carried over is added to the depletion allowance before any limits are applied for the carryover year.

If the bankruptcy estate does not succeed to this attribute, the debtor will retain the carryover credit for future benefit while the bankruptcy estate incurs potential tax from the property that generates the income, which might cause the trustee to abandon such income-producing property.

B. Carryovers of unused IRC Section 179 expense amounts.

IRC Section 179 allows a taxpayer to elect to treat the cost of any IRC section 179 property as an expense for the taxable year in which the taxpayer places the property in service. The IRC section 179 expense is limited based on the income of the trade or business; however, any unused expense may be carried forward indefinitely.[18] Since the unused 179 expense is carryover under IRC Section 179 rather than as an NOL, courts may disallow the estate's use of the expense, which causes the estate to incur additional tax and a windfall to the debtor to retain section 179 expense for future use.

Because the Tax Cuts and Jobs Act of 2017 increased the bonus depreciation under IRC Section 168(k) to 100%, using IRC Section 179 to expense the cost of a property was an

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[15] Treas. Reg. 1.611-1(a)
[16] IRC § 613A(d)(1).
[17] IRC § 613(d)(flush language).
[18] IRC 179(b)(3)(B); Treas. Reg. 1.179-3.

afterthought for virtually all taxpayers. However, starting January 1, 2023, the bonus depreciation under IRC Section 168(k) begins to phase out to 80%, and thereafter, it is reduced by an additional 20% every year until it is at 0% in 2027. Accordingly, IRC Section 179 will play a significant role in determining tax liability in the upcoming years.

C. Excess Business Loss Carryovers IRC Section 461(l)

The Tax Cuts and Jobs Act amended section 461 to include subsection (l), which disallows excess business losses of noncorporate taxpayers if the loss is more than $250,000 ($500,000 in the case of a joint return). This threshold amount will be adjusted for inflation in future years. Any disallowed loss is carried forward as a net operating loss to future tax years.[19] Typically, the bankruptcy estate succeeds in all net operating loss carryovers under IRC Section 1398(g)(1), which would include Section 461(l).

In 2021, Biden's administration proposed a change to IRC Section 461(l) in the "Build Back Better Act" restricting section 461(l) by changing the treatment of the excess business loss carryover to become a deduction attributable to the trade or business generating the loss similar to section 469 passive activity loss limitations.[20] The Green Book explained that this proposal was to limit the deduction of a loss arising from a particular business and to ensure that the loss stays within that business and does not offset other income sources. However, the proposal did not pass, and Congress opted for a much-narrower change in the Inflation Reduction Act of 2022, extending the limitation's application through the 2028 tax year.

Since the Excess Business Loss is an important revenue-raising provision that limits the deduction of business losses, it is likely here to stay. It is important for the bankruptcy estate to succeed in this attribute, especially to ensure that the correct tax liability calculation is achieved, similar to how Treas. Reg. § 1.1398-1 came to be.

D. Claim of Right under IRC Section 1341

The claim of right doctrine requires a taxpayer to recognize income even if they have no fixed right to it. If the income is later returned, IRC Section 1341 allows the taxpayer to deduct

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[19] IRC 461(l)(2).

[20] U.S. Department of the Treasury Green Book, General Explanations of the Administration's Fiscal year 2022 Revenue Proposals, 85 (May 2021), https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf (accessed April 10, 2023).

the change in income in the previous year without amending their prior year's tax return. However, some courts have held that a bankruptcy estate cannot succeed this "computational benefit". *E.g.*, *Cooper v. United States*, No. 3:97CV502-V, 2000 U.S. Dist. LEXIS 8988 (W.D.N.C. May 17, 2000); *DiStasio v. United States*, 22 Cl. Ct. 36, 52 (Cl. Ct. November 16, 1990).

Such an outcome is not fair to the bankruptcy estate because bankruptcy proceedings often last for several years, and scenarios where IRC Section 1341 applies frequently arise, such as:

- Repayment of income previously reported: If an estate includes income in one year and repays it in a subsequent year, it should be eligible to claim a deduction under IRC Section 1341 for the amount repaid.
- Restitution payments: If an estate receives restitution payments for previously reported and taxed income, it should be eligible to claim a credit or refund under IRC Section 1341.
- Settlements or judgments: If an estate receives a settlement or judgment payment that includes taxable and non-taxable amounts, it should be able to claim a credit or deduction for the taxable portion under IRC Section 1341.
- Embezzlement or theft: If an estate is a victim of embezzlement or theft and included the stolen funds in their income in a prior year, it should be eligible to claim a credit or deduction under IRC Section 1341 for the amount stolen.

Allowing the estate to succeed to this attribute would prevent additional tax liabilities that it should not have owed and allow more funds to be available for distribution to creditors.

E. Bad Debt Deduction under IRC Section 166

Bad debt deduction under IRC Section 166 is generally treated as a short-term capital loss. As a result, for an individual taxpayer, the deduction is limited to the capital gains recognized in the year, plus a $3,000 deduction against other income. Unused capital loss can be carried forward indefinitely.[21] However, this bad debt loss is not equivalent to a net operating loss carryover or a method of accounting of the debtor and has been held not to be an attribute

[21] IRC § 1212.

that passes to the bankruptcy estate pursuant to IRC Section 1398(g). Current IRC Section 1398(g) thus preserves the IRC Section 166 deduction for the debtor.[22]

V. CONCLUSION

In conclusion, bankruptcy proceedings can be complex and require careful consideration of tax laws and regulations. Because IRC Section 1398(g) governs which tax attributes belong to the bankruptcy estate, this paper proposes that the IRS issue additional regulations for IRC Section 1398(g) to deal with tax attributes that did not exist at the time of IRC Section 1398(g)'s enactment and to allow the bankruptcy estate to succeed certain tax attributes that properly belong to the estate. This would provide much-needed clarity for debtors, the estates, and their counsel, reduce the risk of additional tax liabilities or needs for litigation, and allow for more funds to be available for distribution to creditors. By updating and clarifying these provisions, the bankruptcy process can be made more efficient, fair, and predictable for all parties involved.

[22] *E.g.*, *Chamberlin v. Comm'r*, T.C. Memo 2000-50 (Feb. 11, 2000); *aff'd*, 88 A.F.T.R. 2d 2001-5151 (2d Cir. 2001), *cert. denied*, 534 U.S. 1163, 122 S. Ct. 1174, 152 L. Ed. 2d 118 (2002).