The Cramdown

The Newsletter of the Tampa Bay Bankruptcy Bar Association

Editor-in-Chief, Robert J. Wahl, Forizs & Dogali, P.A. **Summer 2011**

PRESIDENT'S MESSAGE

by Elena Paras Ketchum Stichter Riedel Blain & Prosser, P.A.

Turning Over the Reins!

It is that time of year again when the reins of the Association are turned over to the next Board of Directors and its officers. Knowing each of the officers and directors, the Association is going to continue to soar this coming bar year.

I want to take this opportunity to thank each of this past year's directors and officers for their tireless efforts, countless hours and awesome enthusiasm on behalf of the Association. Through each of their efforts, the Association this past year continued to provide to its members a variety of offerings, including, monthly CLE luncheons, consumer brown bag luncheons, happy hours, the Cramdown, the website, holiday party, and membership directory.

The Board also relies upon a number of members who volunteer their talents and time to organize such events such as the First Annual Joint TBBBA/HCBA Half-Day Seminar, the C.A.R.E. program, the "Day at Bankruptcy Court" days for area law students, the Annual Golf Tournament and the Annual Dinner. A huge THANK YOU to each and every volunteer!!!

I owe an overwhelming debt of gratitude to each and every attorney and staff member at Stichter, Riedel, Blain & Prosser, P.A. I greatly appreciate their support and encouragement, not only this past year while serving as President of the Association but throughout my time with the firm. I am honored to be a member of the SRBP family and hope to do them proud.

It has, quite simply, truly been an honor and privilege to serve the Association, not only as its President this past year but as a member of the Board of Directors.

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The Tampa Bay Bankruptcy Bar Association
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Officers and Directors

President
Elena Paras Ketchum
Stichter Riedel Blain & Prosser, P.A.
110 E. Madison Street
Tampa, Florida 33602
eketchum@srbp.com
813-229-0144

Vice President
Lara Roeske Fernandez
Trenam Kemker
101 East Kennedy Boulevard, Suite 2700
Tampa, Florida 33602
lrfernandez@trenam.com
813-227-7404

Secretary
Brad Hissing
Kass Shuler Solomon Spector Foyle &
Singer, P.A.
Post Office Box 800
Tampa, Florida 33601
bhissing@kasslaw.com
813-229-0900

Treasurer
Kelley Petry
Kelley M. Petry, P.A.
Post Office Box 7866
Tampa, Florida 33673
kmpetrypa@aol.com
813-873-0713

CLE Chairs
Keith Appleby
Fowler White Boggs Banker, P.A.
Post Office Box 1438
Tampa, Florida 33601
kappleby@fowlerwhite.com
813-222-2081

Edward Peterson
Stichter Riedel Blain & Prosser, P.A.
110 E. Madison Street, Suite 200
Tampa, Florida 33602
epeterson@srbp.com
813-229-0144

Community Service
Lori Vaughan
Trenam Kemker
101 East Kennedy Boulevard, Suite 2700
Tampa, Florida 33602
lvaughan@trenam.com
813-227-7432

Historian
Wanda Hagan Golson
Golson Legal, P.A.
1724 East 5th Avenue
Tampa, Florida 33605
wgg@golsonlegal.com
813-241-0900

Judicial Liaison
Cinthia P. Burnette
Office of the U.S. Trustee
501 E. Polk Street, Suite 1200
Tampa, Florida 33602
cindy.p.burnette@usdoj.gov
813-228-2000

Consumer
Suzy Tate
Jennis & Bowen, P.L.
400 N. Ashley Drive, Suite 2540
Tampa, Florida 33602
state@jennisbowen.com
813-229-1700

Membership
Stephanie Biernacki Anthony
Anthony & Partners, LLC
201 N. Franklin Street, Suite 2400
Tampa, Florida 33602
santhony@anthonyandpartners.com
813-273-5613

Technology
Adam Alpert
Bush Ross, P.A.
1801 N. Highland Avenue
Tampa, Florida 33602
aalpert@bushross.com
813-224-9255

Cramdown
Robert J. Wahl
Forizs & Dogali, P.A.
4301 Anchor Plaza Parkway, Suite 300
Tampa, Florida 33634
rwahl@forizs-dogali.com
813-289-0700

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Changes to Section 547(c)(2) in BAPCPA Significantly eased the Burden of Proof for a Preference Defendant in Asserting the Ordinary Course of Business Defense

by Dennis J. LeVine
Dennis LeVine & Associates, P.A.

Payments made by a debtor to a creditor within 90 days of the bankruptcy filing may represent a preferential transfer. Trustees and debtors frequently file adversary actions under 11 U.S.C. §547 to recover such payments. Nevertheless, the Bankruptcy Code provides a number of defenses to creditors whereby the transfer is protected from avoidance. The most often asserted and litigated defense is under 11 U.S.C. §547(c)(2), where a creditor asserts that the payment was made in the ordinary course of business. According to the 11th Circuit, the purpose of the ordinary course of business protection is "to leave undisturbed normal financial relations, because [such an exception] does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditor during the debtor's slide into bankruptcy." *In re Craig Oil Company*, 785 F.2d 1563, 1566 (11th Cir. 1986) (this section is intended to protect recurring, customary credit transactions that are incurred and paid in the ordinary course of the business of the debtor and the debtor's transferee).

Prior to October, 2005, to qualify under the ordinary course of business exception, § 547(c)(2) required a creditor/transferee to show that the underlying debt was incurred in the ordinary course of business or financial affairs of both parties, and that both (a) the transfer was made in the ordinary course of business or financial affairs of both parties, and (b) the transfer was made according to "ordinary business terms." In October 2005, Section 547(c) was amended by BAPCPA. The specific changes to § 547(c)(2) included in BAPCPA significantly eased the burden of proof of a preference defendant regarding the ordinary course of business defense. The changes in the statute are shown as follows (in bold):

> (c) The trustee may not avoid under this section a transfer—
> (2) to the extent that such transfer was — (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was —
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee, or
> (B) made according to ordinary business terms;

The 2005 amendments to §547(c)(2) reduced the number of elements needed to establish the ordinary course of business defense from three to two. Before the amendment, the transferee was required to establish both that the transfer was made in ordinary course of the debtor and that the transferee, AND made in accordance with ordinary business terms. BAPCPA changed the "and" to "or". Now, as long as the debt was incurred in the ordinary course of business, proof of only one of these two elements must be shown. Now, a preference defendant must show only: (i) that the debt was incurred in the ordinary course of business, measured in light of the relationship between the Debtor and Defendant; AND (ii) either (a) the payment was made in the ordinary course of affairs between the debtor and Defendant OR (b) was made according to ordinary business terms." *In re Ameri P.O.S.,* 355 B.R. 876, 833 (Bankr. S. D. Fla. 2006); see also *In re Moltech Power Sys. Inc.,* 327 B.R. 675, 683-685 (Bankr. N.D. Fla. 2005).

(i) Debt Incurred in the Ordinary Course of Business of the debtor and the creditor

To qualify for protection from avoidance as a preference, a transfer made by the debtor within 90 days of filing must first be shown to have been *incurred* in the ordinary course of business. This test is determined "in light of the relationship between the debtor and the defendant." *In*

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re Ameri P.O.S. Inc., 355 B.R. 876, 883 (Bankr. S.D. Fla. 2006). The case law indicates that Courts should look at whether the debt was the result of an arm's-length transaction with a legitimate purpose. *In re Nobles*, 2010 WL 3260128, 4 (Bankr. M.D. Ga. 2010); *Huffman v. New Jersey Steel Corp. (In re Valley Steel Corp.),* 182 B.R. 728, 735 (Bankr. W.D. Va. 1995) ("courts generally are interested in whether or not the debt was incurred in a typical, arms-length commercial transaction that occurred in the marketplace"); *In re Express Factors, Inc.,* 2005 WL 6486099, 5 -6 (Bankr. N.D. Ga. 2005).

In *In re Express Factors, Inc.,* the debtor's president procured a $500,000 loan from defendant, and the funds were used as capital in the debtor's factoring business to help fund its purchase of receivables. The parties executed a promissory note that specified the terms of repayment, with interest at a commercially reasonable rate. The Court focused on the nature of the original transaction creating the debt, and found that the loan was entered into by the parties on commercial terms for a business purpose:

> "[c]ourts generally are interested in whether or not the debt was incurred in a typical, arms-length commercial transaction that occurred in the marketplace, or whether it was incurred as an insider arrangement with a closely-held entity." Huffman v. New Jersey Steel Corp. (In re Valley Steel Corp.), 182 B.R. 728, 735 (Bankr. W.D. Va. 1995), cited in Toy King Distribs., 256 B.R. at 114. Subsection (c)(2)(A) "is required merely to assure that neither the debtor nor the creditor do anything abnormal to gain an advantage over other creditors, an extensive showing that such transactions occurred often, or even regularly, is not necessary. The transaction need not have been common, it need only be ordinary." Valley Steel Corp., 182 B.R. at 735 citing Campbell v. Cannington (In re Economy Milling Co.), 37 B.R. 914, 922 (D. S.C. 1983).

Courts also look at the following factors to determine whether or not a payment was incurred in the ordinary course of business: "(i) the length of time the parties were engaged in the transaction at issue; (ii) amount or form tendered differed from past practice; (iii) engaging in unusual collection or payment activity; (iv) presence of any special circumstances." *In re Moltech Power Sys Inc.,* 327 B.R. 675, 683-685.

(ii) Payments made in the Ordinary Course of Business of the Debtor and Creditor

Courts have interpreted the "ordinary course of business or financial affairs" requirement to be subjective in nature. The analysis of this element requires the Court to consider whether the transfer was ordinary in relation to other business dealings between that creditor and the debtor. This analysis is based in part on the historical relationship between the debtor and the transferee. *In re Globe Manufacturing Corp.,* 567 F.3d 1291, 1298 (11th Cir. 2009), quoting *In re Fred Hawes Org., Inc.,* 957 F.2d 239, 244 (6th Cir.1992); see also *In re Issac Leaseco*, 389 F.3d 1205, 1210 (11th Cir. 2004); *In re Molded Acoustical Prods., Inc.,* 18 F.3d 217, 223-28 (3rd Cir. 1994). The Court's factual inquiry under the subjective element of 547(c)(2)(A) also requires an evaluation of the circumstances surrounding the payments made during the preference period. In *Craig Oil*, the 11th Circuit stated that "[s]ubsection 547(c)(2) protects those payments that do not result from "unusual" or extraordinary" debt collection practices." 785 F.2d at 1567.

The Courts looking at the ordinary course of business defense find that flexibility may be applied when comparing preference payments with payments that occurred before the preference period. To be in considered in the "ordinary course of business" a payment "need not possess a rigid similarity to each past transaction ...; [the Defendant] need only 'demonstrate some consistency with other business transactions' ". *In re JSL Chemical Corp.,* 424 B.R. 573 at 581 quoting *J.P. Fyfe, Inc. v. Bradco Supply Corp.,* 96 B.R. 474, 476-77 (D. N.J. 1988). Therefore, the payments during the preference period do not need to occur exactly when the pre-preference payment occurred. It is sufficient that

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the payments occurred around the same time as the prepreference period payments.

When the transactions between the debtor and creditor during the preference period — and before the preference period — are consistent, they generally are protected from avoidance under Section § 547(c)(2). This subjective analysis primarily rests on the prior dealing between the debtor and the defendant transferee. *In re Globe Manufacturing Corp.,* 567 F.3d 1291, 1298 (11th Cir. 2009); *Moltech Power,* 327 B.R. at 680. ("Under this test, the parties' transactions during the pre-preference period are examined to determine the parties' ordinary course of business. Transactions occurring during the preference period are then compared to the parties' pre-preference transactions to see if they were made in a similar manner); see also *In re Felt Mfg. Co.,* 2009 WL 3348300 (Bankr. D. N.H. Oct.16, 2009) ("the overall controlling consideration is whether the transactions between the debtor and the creditor both before and during the 90-day preference period were consistent"); *In re JSL Chemical Corp.,* 424 B.R. 573, 579 (S.D. Fla. 2010).

In *In re L. Bee Furniture, Inc.*, the plaintiff argued that the defendant conducted unusual collection activity because each payment made during the preference period was made in response to the defendant's telephone contact with the debtor. The Court found that defendant followed its routine collection activities by sending invoices to the Debtor prior to the due date, and if not paid followed by sending past due notices, then followed by phone calls. These activities were routine over the life of the loan, and the defendant's collection activities did not increase during the preference period. The Court held that this was not unusual collection activity because all payments over the course of dealing between the debtor and the defendant resulted from the same type of telephone contact that took place during the preference period. *In re L. Bee Furniture Co., Inc.,* 203 B.R. 778, 783.

(iii) The Payments Were Made According to Ordinary Business Terms

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A creditor can prevail under § 547(c)(2) by showing that the transfer either was (A) made in the ordinary course of business or financial affairs of the debtor and the transferee, or (B) made according to ordinary business terms. To satisfy the objective standard under § 547(c)(2)(B) – the "ordinary business terms" requirement – a creditor must provide proof that the preference payment was consistent with industry standards. *In Re: Globe Manufacturing Corp.,* 567 F.3d 1291, 1298 (11th Cir. 2009). When evaluating "ordinary business terms," Courts look at the practices of other firms in the industry with regard to payments, and compare them to payments from the debtor to the creditor which took place during the preference period. *In re A.W. & Associates, Inc.,* 136 F.3d 1439 (11th Cir. 1998). In *In A.W. & Associates*, the 11th Circuit noted "'[O]rdinary business terms' refers to the range of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of subsection c." *In A.W. & Associates*, 136 F.3d 1439, 1442. The key inquiry here is whether the payment arrangements fall within the range that is considered normal within a particular industry. *In re Issac Leaseco, Inc.*, 389 F.3d 1205, 1212 (11th Cir. 2004). In *In re Leaseco Inc.*, the court noted the importance of the length of the relationship between the parties: "[W]hen the parties have had an enduring, steady relationship…the creditor will be able to depart substantially from the range of terms established under the objective industry standards". 389 F.3d at 1212, *quoting In re Molded Acoustical Prods.*, 18 F.3d 217,226 (3rd Cir. 1994)). In general, payments would be protected under Section 547(c)(2) where they do not substantially departed from the range of established terms under the objective standard.

In *A&W & Associates*, the Eleventh Circuit re-emphasized its position that courts are required to consult industry standards. The Court noted that "[i]ndustry standards do not serve as a litmus test by which the legitimacy of a transfer is adjudged, but function as a general backdrop against which the specific transaction at issue is evaluated." *In re A.W. & Associates, Inc.*, 136 F.3d 1439,1442-1443 (11th Cir. 1998). The 11th Circuit quoted the Seventh Circuit's test in the seminal case of *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029, 1032-33 (7th Cir. 1993), stating "[t]he Seventh Circuit offered two rationales for consulting industry standards: (1) comparison to industry standards serves the evidentiary function of providing a basis to evaluate the parties' self-serving testimony that an extraordinary transaction which was in fact intended as a preference towards a particular creditor was instead part of a series, transactions within a business relationship, and (2) reference to industry standards reassures other creditors that deals have not been worked out favoring a particular creditor, which would permit a preference to slide under the § 547 fence."

When consulting the industry standard, Courts should review each challenged payment in light of similar payments in the industry, and determine whether or not the transfers were intended as preference. Where payments are in line with industry standards as shown by the consistent payment pattern between the parties over the life of a lengthy agreement, and do not fall outside the standard range of business practices, they should fall squarely within the protection of §547(c)(2)(B).

The case of In Re Southwest Recreational Industries Inc., 2008 WL 2816948, 9 (Bank. N.D. Ga. 2008) illustrates the impact of the relaxed proof provisions in § 547(c)(2). The case was decided based on the pre-BAPCPA provisions of § 547(c)(2). The Court found that the debt was incurred in the ordinary course of business, and found that the creditor's preferential payments were all made according to ordinary business terms; however, the Court found that the subjective requirement (i.e. payment in the ordinary course of business or financial affairs of the debtor and creditor) was not met. As a result, the Court found that the transfers made by the debtor to the creditor were not entitled to the protection of § 547(c)(2). Had the *In Re Southwest Recreational Industries Inc.* case been filed under the current, more relaxed, provisions of section § 547(c)(2) as amended by BAPCPA, the preferential payments would have been protected from avoidance because the defendant provided proof of one of the two subsections of § 547(c)(2).

The Cramdown is published four times per year. Advertising rates are as follows:

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The TBBBA Golf Tournament had its very first hole-in-one, by Stephen Muldrow, an Asst. US Attorney in Tampa, FL. This year's tournament was held May 6, 2011, at Bay Palms Golf Club.

Roberta A. Colton Named Top 10 Lawyer by Florida Super Lawyers

The law firm of Trenam Kemker is pleased to announce that Roberta A. Colton, a shareholder in the firm's Tampa office has been named one of the Top 10 Lawyers in the State of Florida by Florida Super Lawyers. Super Lawyers' attorney-led research staff searches for lawyers who have attained certain honors, results or credentials, which indicate a high degree of peer recognition or professional competence. The Top 10 Lawyers received the highest point totals in the Florida Super Lawyers 2011 nomination, research and blue ribbon review processes.

Roberta joined the firm in 1983 and has been a Shareholder since 1988. She serves on the firm's three person Management Committee. Roberta's practice areas include federal bankruptcy (creditor and debtor representation), foreclosure/lender liability, creditor committees, bankruptcy trustee representation, commercial litigation, and bankruptcy asset sales. Prior to joining the firm, Roberta served as a judicial law clerk for the Hon. James C. Hill, Eleventh Circuit Court of Appeals in Atlanta, Georgia.

Founded in 1970, Trenam Kemker ranks among the largest law firms in Florida, with offices in Tampa and St. Petersburg. Trenam Kemker works nationally with clients in the areas of business reorganization and bankruptcy, business transactions, commercial litigation, construction law and government contracting, employment law, health care, employee benefits, real estate transactions and lending, and wealth planning and preservation. The firm is committed to the service of its clients, the community and the improvement of the legal profession. For more information, visit Trenam Kemker online at www.trenam.com.

Individual Retirement Accounts—No Longer Safe to Presume Exempt Property Protection?

by Derrick Clarke

J.D. 2011, Stetson University College of Law; Moot Court Board Member; and Participant in 19th Annual Conrad Duberstein Bankruptcy Moot Court Competition

Mark was a hardworking employee at a manufacturing company downtown. He was financially established having opened up high-yield checking and savings accounts and a personal brokerage account for the purposes of high-risk investments at a local brokerage firm (Firm). Realizing that he was not getting any younger, Mark wished to prepare for retirement and returned to the Firm seeking to set up an individual retirement account (IRA). However, when establishing the IRA, the Firm requested that Mark grant the Firm a security interest in his IRA assets to cover any indebtedness that may arise from his Firm accounts. Excited to finally set up an IRA and prepare for retirement, Mark did not give the Firm's condition much consideration and agreed immediately.

Unfortunately, a few years later Mark filed Chapter 7 bankruptcy protection as he endured great financial hardships due to layoffs and an economic downturn in the area. He simply needed a fresh start and was initially relieved to learn from his attorney that IRAs are exempt property. However, the trustee challenged the status of Mark's IRA claiming that Mark's agreement to grant the Firm a security interest in his IRA assets was a "prohibited transaction" and therefore the IRA was not exempt property. Bewildered by the Trustee's challenge, Mark frantically met with his attorney to resolve this issue.

Mark's predicament illustrates the rare situation when an IRA may not retain its exempt-property status when filing Chapter 7 bankruptcy protection.[1] This Article will explain how IRA assets can still be challenged during bankruptcy proceedings when the debtor must rely on federal exemptions.

IRA Exemption: *Rousey v. Jacoway*

The Cornerstone of Chapter 7 bankruptcy petition filings has been marked by the debtor's ability to ensure a fresh start by claiming exempt property. In the case of IRAs, the Supreme Court has made it very clear in *Rousey v. Jacoway*[2] that IRAs are exempt property under § 522(d)(10)(E).[3] In *Rousey*, the Supreme Court stated that the debtor's right to receive payment from his IRA must meet the requirements under the statute to be exempt property.[4] To establish the exemption under the statute, the debtor's right to receive payment must be from a "stock bonus, pension, profitsharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor…."[5]

The Supreme Court ruled that a debtor's right to payment from an IRA qualifies as a "similar plan or contract" as set forth under § 522(d)(10)(E)."[6] The Court reasoned that IRAs are "similar" to the specific contracts or plans mentioned in the statute in that they have the same primary purpose, which is to provide income as a substitute for wages (and not merely as savings accounts). The Supreme Court then listed the following characteristics of IRAs as support for this conclusion: (1) The requirement distributions begin at age 70½; (2) the tax deferral of the account until distribution; (3) the

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1 It should be emphasized that Mark's rare situation exemplifies bankruptcy petition filings where the debtor must depend solely on federal exemptions.

2 Rousey v. Jacoway, 544 U.S. 320 (2005).

3 Id. at 334–35.

4 Id. at 325–26.

5 11 U.S.C. § 522(d)(10)(E) (2006).

6 Rousey, 544 U.S. at 329–30.

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penalty on distributions before age 59½; and (4) the 50 percent penalty if required minimum distributions after age 70½ were not made.[7]

Additionally, the Supreme Court concluded that the right to receive payment under an IRA is "on account of age."[8] The Court reasoned that because an IRA has a 10 percent penalty for withdrawing before the age of 59½, and when achieving this age such penalty is removed, an individual has a right to payment "on account of age." The Court further stated that the 10 percent penalty imposed for early withdrawal is a substantial barrier making IRAs more than mere savings accounts. The Supreme Court also determined that IRAs met all other requirements under the statute.

The Challenge to IRA Exemption

The challenge to the exemption is centered on the premise that an IRA can lose its status as an IRA and instead become a personal or regular savings account. An IRA may no longer retain its status when an IRA is involved in a prohibited transaction.[9] Under § 4975(c)(1)(B), prohibited transactions constitute as any direct or indirect, "lending of money or other extension of credit between a plan and a disqualified person." When looking to § 4975(e), IRAs constitute a "plan" under subsection (1)(B) and IRA owners are "disqualified persons" to a transaction under subsection (2)(A) as they are fiduciaries to the "plans."[10]

When IRA owners grant a security interest in their IRA

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7 Id. at 331–32.

8 Id. at 327–28.

9 See 26 U.S.C. § 4975(c)(1)(B) (2006).

10 See Willis v. Menotte, No. 09–82303–CIV, 2010 WL 1408343, at *6–7 (S.D. Fla. Apr. 6, 2010).

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assets to cover indebtedness on their accounts, it is an extension of credit from a "plan" (the IRA) to a disqualified person (the IRA owner) constituting as a "prohibited transaction" under § 4975(c)(1)(B). This assertion is supported by the Department of Labor's (DOL) authority to interpret § 4975.[11] In 2009, the Department of Labor issued DOL Op. 2009-03A and determined that if an IRA owner grants a security interest in his or her IRA's assets to a broker to cover the indebtedness of the IRA owner owed to the Broker then the IRA would constitute as a "prohibited transaction" under § 4975(c)(1)(B).[12]

Once an IRA owner commits a prohibited transaction under § 4975 (c)(1)(B), the IRA becomes a regular savings account as the IRA no longer enjoys tax benefits and deferrals on the account.[13] This condition is precisely what prevents the former IRA from being claimed as exempt property as it is no longer similar to a stock bonus, pension, profitsharing, or annuity plan under § 522(d)(10)(E).[14] Consequently, the former IRA is like a personal savings account and no longer exempt property of the estate under the rationale set forth in *Rousey*.[15]

Mark's IRA is Not Exempt Property

Mark's IRA account with the Firm did not retain exempt property status. When Mark agreed to grant a security interest in his IRA assets to the Firm to cover his indebtedness, this resulted in an extension of credit by the IRA to the IRA owner—from a "plan" to a "disqualified person"—constituting a "prohibited transaction" under § 4975(c)(1)(B). Mark's decision transformed his IRA into a regular savings account no longer subject to the withdrawal penalties and tax benefits of an IRA, thereby making the IRA property of the estate.

Mark's assertion that his IRA account is exempt property is not consistent with the Supreme Court's holding in *Rousey*. In *Rousey*, the Supreme Court held that IRA accounts were exempt property when the account complied with the requirements of § 522(d)(10)(E). Since Mark's IRA account no longer enjoys the tax benefits prior to distribution of IRA assets and is subject to penalties, it does not qualify under "similar plans or contracts" within the meaning of § 522(d)(10)(E). Mark's IRA was involved in a prohibited transaction under § 4975 and it no longer serves the purpose of income that substitutes for wages. When applying federal exemptions, Mark's former IRA account is not exempt property under § 522(d)(10)(E) for purposes of his Chapter 7 bankruptcy petition filing.

11 The Secretary of Labor possesses the authority to issue interpretations regarding 26 U.S.C. § 4975 under the Presidential Reorganization Plan No. 4 of 1978, effective December 31, 1978.

12 Dep't of Labor Advisory Op. 2009-03A (Oct. 27, 2009), http://www.dol.gov/ebsa/regs/aos/ao2009-03a.html.

13 See 26 U.S.C. § 408(e)(2) (2006).

14 See Rousey, 544 U.S. at 330–31.

15 See id.; see also Willis v. Menotte (In re Willis), Nos. 10–11980, 2011 WL 1522383, at *1 (11th Cir. 2011 Apr. 21, 2011) (ruling that when a debtor engages in a prohibited transaction under § 4975(c)(1)(D) (thereby causing his or her IRA assets to lose tax exempt status under § 408(e)(2)), federal exemptions will not apply and such assets become property of the bankruptcy estate).

The Tampa Bay Bankruptcy Bar Association held its Annual Rays Night August 5, 2011, at Tropicana Field to cheer on the Tampa Bay Rays. The event was a night of fun amongst fellow colleagues, family and friends.

How to Properly Handle 1099 Income From Mortgage Foreclosures and Short Sales

by: R. Lawrence (Larry) Heinkel, Esq.
Larry Heinkel is a tax and bankruptcy attorney who helps businesses and individuals nationwide resolve their IRS and major debt problems, all from his main office in downtown St. Petersburg, FL. He can be reached at: 727-894-2099 or Larry@TaxProblemSolver.com or Larry@MyFloridaBankruptcyLawyer.com.

Every year thousands of people lose their homes and other real properties through foreclosure or through a “short sale”. As financially devastating and emotionally traumatic as these transactions can be by themselves, the process is often further compounded by the issuance of a form 1099 which reports to the Internal Revenue Service (“IRS”) the amount of indebtedness that the lender is “writing off” or “forgiving”. The purpose of this article is to educate you, the professional realtor, on how your client should treat the receipt of the form 1099 expected to be issued.

What a 1099 “Means”

When the property is foreclosed upon or the short sale closed, the net sales price is applied toward the debt, which does not satisfy the entire debt. The rest is “forgiven” and written off. The amount reported on the 1099 is the amount of the loan that was not “repaid” by your client. It is NOT the total amount of debt on the property.

For example: assume your client owes $500k on a house worth only $350k. If the house is foreclosed (or short sold) for $350k (which is applied to the $500k debt), there is a “deficiency” of $150k. The lender can sue your client to collect this deficiency or may write it off and issue your client a 1099 for the $150k.

Bifurcation of the Transaction

What many people fail to realize is that a foreclosure or short sale is in reality not a single transaction but two. The first part is a “sale or exchange” of the subject real property for a sales price equal to the fair market value of the property. The second part is the forgiveness of the debt that exceeds the fair market value of the property. These two transactions must be analyzed separately.

The first part (the “sale” of the property for cancelation of debt equal to the property’s fair market value) will typically be (a) tax-free gain on the sale of the debtor’s principal residence under section 121 of the Tax Code, or (b) a tax loss because the property’s adjusted tax basis exceeds its fair market value, or (c) a tax gain because the property’s fair market value exceeds its adjusted tax basis.

For example, again assume your client owes $500k on rental property worth $350k which has a tax basis of $300k. Since the property is worth $350k, the lender has, in effect, accepted a $350k payment on the $500k debt, leaving a balance owed of $150k. So, your client has sold its rental property for $350k and, because the tax basis is only $300k, your client has realized a $50k gain and is taxed to your client in the same manner as if your client had sold the property to an unrelated party for $350k. The second part of the transaction, the unpaid debt of $150k, is written off by the lender who then issues the debtor a 1099 for that amount to be analyzed separately.

General Rule of Forgiveness of Debt Taxation

Generally, debt that is written off or forgiven by a lender constitutes ordinary taxable income to the debtor. To avoid recognizing taxable income, your client has to find “relief” - an exception - to the general rule. Below are exceptions that may be available to your client. Use IRS form 982 to report the exception.

Debt Forgiveness on Principal Residence

The Mortgage Debt Relief Act of 2007 (enacted 12-20-07) allows non-recognition to certain debt that was

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forgiven on your client's "principal residence". To qualify, these tests must all be satisfied:

a. The debt must be forgiven during 2007 thru 2012;
b. A "principal residence" is the "main" home (your client does not have to have lived in the house for 2 of the last 5 years as required for nonrecognition of gain on the sale of a principal residence);
c. The exception is capped at $2 million in forgiven debt (half for singles);
d. The write-off must be due to decline in home's value or taxpayer's financial condition (which means from loan modification or foreclosure);
e. Debt must have been (i) secured by the home (not unsecured loans); (ii) *used to buy, build or substantially improve* the principal residence, or (iii) *refinance debt* used *for such purposes* (i.e. 2nd mortgages taken out to pay debts, take vacations, etc. do not qualify for this exclusion – look for other, possible exclusions below).

Discharge Occurs when Taxpayer is Insolvent

Your client can avoid taxable income on the forgiven debt to the extent your client is "insolvent". "Solvency" is measured by subtracting amount of debt from fair market value of assets. "Assets" includes both exempt *and non-exempt* assets ("Exempt" assets include homestead equity, qualified retirement plans, IRA's, life insurance policies and annuities). This exclusion is limited to *the extent of* the insolvency.

Continuing with your client with $150k of 1099 income: assume he has $100k of other debt (credit cards, judgments, etc.), IRAs of $40k, and other miscellaneous assets of $10k. The assets total $50k; the debts $250k; a net worth of -$200k. The forgiven debt ($150k) is

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excluded to the extent of the insolvency ($250k) so the entire amount is tax-free.

On the other hand, assume the IRA is worth $200k; your client has homestead equity of $100k, and a life insurance policy with a cash surrender value of $50k. In this case, the assets total $350k and the debts total $250k. The client has a positive net worth of $100k. That portion of the forgiven debt equal to your client's solvency ($100k) is taxable. Once your client offsets his solvency of $100k with $100k of the forgiven debt, the extra forgiven debt ($50k) is not taxable.

Discharge Occurs in Bankruptcy

Income recognition is avoided if the debt obligation was discharged in a bankruptcy. Many debtors do not qualify for exclusion under the "insolvency" exception due to the existence of exempt assets that render them solvent. So they must file bankruptcy to avoid income recognition (but keep the exempt assets!).

Here's the 64,000 Question: if your client is solvent due to the existence of exempt assets, and wants to file bankruptcy to avoid income recognition, *does the filing of the bankruptcy have to precede the issuance of the form 1099*? It is presently unclear. To be safe, the prudent debtor should file for bankruptcy protection prior to the issuance of the form 1099.

Conclusion

Most people we deal with do not have to fear "forgiveness of debt" income because most people are insolvent and/or file bankruptcy to discharge their obligations under the loans. Only those clients who have either (i) substantial exempt assets and do not file BK before the 1099 occurs, or (ii) substantial built-in (inherent) gains in their surrendered properties, have serious concerns. Regardless, your client should seek competent legal help in this area of law. Hopefully this article will help you help your clients.

The TBBBA Annual Installation Dinner
was held June 2, 2011, at the Palma Ceia Golf & Country Club. Lauren Lewis and David McClelland were the two recipients of the Alexander L. Paskay Scholarship Award.
Robert Glenn received the Douglas P. McClurg Professionalism Award.

In Re Smith: "A Remarkable Chutzpah"

by: Joanna McDonald,
The University of Texas School of Law, J.D. Candidate 2013

The appellant debtors had filed a motion to reopen their Chapter 7 case to allow them to pursue adversary proceedings against their former trustee and the insurer who issued the trustee's surety bond. The Bankruptcy Court and District Court denied this motion and the 2nd Circuit affirmed. The 2nd Circuit also ordered appellants and their counsel to show cause why sanctions should not be imposed. The appellants' complaint against the trustee was based on the trustee's allegedly negligent failure to pursue two pending civil suits raised by the appellants. The appellants' complaint against the trustee's bond-issuer was based on the issuer's alleged failure to ensure the trustee's faithful performance of his duties. The 2nd Circuit noted that both civil suits in question had been pending for several years before the initiation of the bankruptcy, that the appellants had failed to appeal the Bankruptcy Court's decision that the trustee was not required to pursue the claims, and that one of the appellants was able but declined to pursue these claims herself. Based on these facts, the 2nd Circuit affirmed denial of the appellants' motion to reopen stating that "the appellants' criticism of the trustee's failure to prosecute the... actions evidences a remarkable chutzpah." "A remarkable chutzpah" appears to here mean "a remarkable audacity."

Tax Issues for Homeowners Facing Foreclosure

The following article appeared previously in the HCBA Lawyer Magazine as an article from the Tax Law Section.

by Justin J. Klatsky, Esq.

"With foreclosure on the horizon for many Floridians, practitioners will likely find themselves speaking with clients planning for, worrying about, or dealing with home foreclosures."

In the month of September, home repossessions by lending institutions set a historic record – this was the first time that over 100,000 foreclosures occurred in one month.[1] During that same month Florida continued to rank in the top five states for number of foreclosures.[2] With foreclosure on the horizon for many Floridians, practitioners will likely find themselves speaking with clients planning for, worrying about, or dealing with home foreclosures. This article serves to introduce and explain the most common tax law issues pertaining to foreclosure.

A loan of money to a borrower does not create income, because of a prior obligation to repay the loan; however, if this obligation to repay is discharged for less than the amount due, then the borrower has an accession to wealth and gross income to the borrower.[3] This concept is referred to in the Internal Revenue Code as "income from discharge of indebtedness," but is often referred to by practitioners as "cancellation of indebtedness income" (or commonly "COD income"). COD income is taxable, unless excepted or excluded by some other provision of the Code.

With this basic understanding of the climate and the concepts, there are three common questions asked by those facing foreclosure: (1) what is the importance of Form 1099-A or -C, (2) when does a borrower have to account for this income on his or her taxes, and (3) does the borrower have any way to not pay this tax?

When a lender forecloses on a home, that lender issues either a 1099-A, which is later followed by a 1099-C, or just a 1099-C. The 1099-A is an informational form that the creditor is required to file with the IRS, recording the foreclosure and/or abandonment of property. If the abandonment or foreclosure and a discharge of indebtedness occur within the same year, then the lender is only required to file the 1099-C, which provides notice to the IRS that there has been a discharge of indebtedness for more than $600. It is the 1099-C that indicates that there is COD income through some identifiable event,[4] but, while a deficiency judgment may be unlikely, the 1099-C should not be read as a guarantee that the creditor will not pursue a deficiency judgment.[5]

Many timing questions on realization of COD income stem from a misunderstanding of the purpose of the 1099-A and 1099-C. If there is a -C, then it will determine the timing. The borrower is responsible, however, for proper filing of his or her return, and there are circumstances where the lender may delay filing a 1099-C, not file for the proper year, or file a -C but also pursue a deficiency judgment. The timing issue involves a close intertwining of tax and real property law, but they can diverge on this issue. Absent a 1099-C or given contrary facts, the borrower will have realization of income when it is clear that the debt will not be repaid, there is an agreement between the parties for satisfaction of the debt, there has been a judicial determination, the statute of limitation on collection has run, or some other finalizing event.[6]

The borrower may now seem to be in the position of losing his or her home and having a large tax liability. There are two common exceptions to exclude the COD income from gross income: insolvency and qualified principal residence indebtedness. The insolvency exception provides that COD income will be excluded from the borrower's income to the extent the borrower was insolvent prior to the cancellation,[7] and insolvency

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1 Corbett B. Daly, *September Home Foreclosures Top 100,000 for First Time*, REUTERS, Oct. 14, 2010 *available at* http://www.reuters.com/article/idUSTRE69D0SF20101014.

2 *Id.*

3 I.R.C. § 61(a)(12).

4 See Treas. Reg. § 1.6050P-1(b)(2).

5 Les Christie, *You Lost Your House but You Still Have to Pay*, CNNMONEY.COM, Feb. 10, 2010 available at http://money.cnn.com/2010/02/03/real_estate/foreclosure_deficiency_judgement/.

6 *See* Leonard L. Silverstein, et al., "Discharge of Indebtedness, Bankruptcy and Insolvency," 540 Tax Mgmt. (BNA) U.S. Income at, A-15 (2009).

7 I.R.C. §§ 108(a)(1)(B), 108(a)(2)(B), 108(a)(3).

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is defined as liabilities in excess of the fair market value of assets.[8] As a response to the mortgage crisis, homeowners can exclude from income debt forgiveness that arose from 2007 through 2012 as a result of forgiveness of "qualified principal residence[9] indebtedness" that does not exceed $2,000,000 for married couples filing jointly and $1,000,000 for others.[10] The general requirements are: (1) the home is the principal residence of the borrower, (2) the money was used to buy, build, or substantially improve the property, and (3) the cancellation was due to either a decline in the value of the home or the borrower's financial condition.[11] Either exception, insolvency or qualified principal residence indebtedness, can be claimed by filing a Form 982.

Postscript by Jake Blanchard

I spoke with the Author of the Tax Issues for Homeowners Facing Foreclosure article, Justin J. Klatsky, Esq., and we thought that an addition to the article for the bankruptcy bar might be helpful. The Author points out there are two common exceptions to exclude the COD income from gross income: insolvency and qualified principal residence indebtedness. Another important exception is bankruptcy.

IRS Form 982 has check box 1a "Discharge of indebtedness in a title 11 case." Furthermore, page 3 of Form 982 states "A title 11 case is a case under title 11 of the United States Code (relating to bankruptcy), but only if you are under the jurisdiction of the court in the case and the discharge of indebtedness is granted by the court or is under a plan approved by the court." Page 3 of Form 982 further states "the term discharge of indebtedness conveys forgiveness of, or release from, an obligation to pay."

The definitions on IRS Form 982 seem to imply that the borrower may exclude COD income on debt that was forgiven *before* the borrower filed bankruptcy. As the Author pointed out the 1099-C "should not be read as a guarantee that the creditor will not pursue a deficiency judgment." A lender may be able to file a 1099-C and still pursue a deficiency judgment. Therefore it can be argued that as long as the bankruptcy was filed and the debt was properly scheduled it should fall under the bankruptcy provision of Form 982 even if the debtor was already issued a form 1099-C.

There is a huge caveat to the Form 982 as it relates to bankruptcy. If the lender formally agreed to waive the deficiency, made an agreement with the borrower to settle the debt, or the statue of limitations has passed *before* the debtor filed for bankruptcy, the debtor may be excluded from using the bankruptcy provision in IRS Form 982 and may be liable for the taxes on the COD income.

8 I.R.C. § 108(d)(3).

9 Principal Residence defined in I.R.C. § 121.

10 I.R.C. §§ 108(a)(1)(E), 108(h).

11 *Id.*

The Solemn Oath of the Cambodian Legal System

In the United States, the usual oath required of those who will give witness to court asks: "Do you swear to tell the truth, the whole truth, and nothing but the the truth, so help you God?"

In the Cambodian legal system, an oath to tell the truth is is also required. Because of Buddhism – the prevailing religious belief in Cambodia – does not believe in a god, the oath is typically sworn by Buddha, the spirits of the courtroom, or the ghosts of famous Khmer warriors. The wording threatens dire punishments for those who would testify falsely:

"If I am home, let fire destroy my house for 800 reincarnations; if I am in a boat, let it sink for 800 reincarnations; when I become a ghost, let me eat bloody pus, or swim in bowling chili oil for 800 reincarnations."

The Cramdown
4301 Anchor Plaza Parkway, Suite 300
Tampa, FL 33634