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Federal Income Tax Consequences for Individuals in Bankruptcy

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Background

- The Bankruptcy Code includes provisions for five different types of cases:
 - Chapter 7 (liquidation)
 - Chapter 9 (adjustment of debts of a municipality)
 - Chapter 11 (reorganization)
 - Chapter 12 (adjustment of debts of a family farmer or fisherman with regular annual income)
 - Chapter 13 (adjustment of debts of an individual with regular income)



Background

- A Chapter 7 bankruptcy case involves the liquidation of a debtor's assets and, after payment of administrative expenses, distribution of the liquid assets to the creditors.
- A Chapter 11 bankruptcy case involves relief from debt and creditor collections while reorganizing.
- A Chapter 13 bankruptcy case involves repayment of various debts over an extended period of time from the debtor's future income.



Tax Consequences for an Individual in Chapter 7 or Chapter 11

Bankruptcy Estate

- IRC §1398 applies to any case under chapter 7 or chapter 11 of the Bankruptcy Code.
- A separate taxable entity is created in these cases, and a federal tax return must be filed by the bankruptcy estate.
- Since IRC §1398 does not apply to cases under chapter 13 of the Bankruptcy Code, no separate taxable entity is created in such a situation.



Ed – The Example



Ed Files for Bankruptcy



Ed in Bankruptcy

Ed

Ed's bankruptcy estate, a separate taxable entity



Tax Consequences for an Individual in Chapter 7 or Chapter 11

- Transfers between the estate and the debtor
 - IRC §1398(f)(1): “A transfer (other than by sale or exchange) of an asset from the debtor to the estate shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the estate shall be treated as the debtor would be treated with respect to such asset.”



Tax Consequences for an Individual in Chapter 7 or Chapter 11

- Taxable Year Questions
 - IRC §1398(d)(2)
 - The debtor may elect to close her taxable year as of the day prior to the date the case commences.
 - In the case of a married individual, the spouse may elect to have the debtor's election apply to the spouse, but only if the debtor and the spouse file a joint return for such taxable year.
 - The election to close the taxable year may be made only on or before the due date for filing the return for the applicable taxable year.
 - Any such election, once made, is irrevocable.
 - If no election is made, any tax liability for the full taxable year will be the obligation of the debtor, not the bankruptcy estate.



Tax Consequences for an Individual in Chapter 7 or Chapter 11

Making the Election – General rules

Short Year Tax Liability:

- If the debtor will have a tax liability for the taxable year that closes the day before the commencement date of the bankruptcy, the election to close the taxable year should be made.
- When such an election is made, the tax liability for the short taxable year becomes a claim against the estate.
- Although the tax liability is most likely nondischargeable in bankruptcy, the debtor will not have personal liability for the tax if the assets of the bankruptcy estate are sufficient to satisfy the tax liability.



Ed's Taxable Year



- Ed filed his bankruptcy petition on June 1, 2012.
- For the full 2012 taxable year, Ed would have income of \$90,000 and a tax liability of \$20,520 if he does not elect to terminate his taxable year at the commencement of bankruptcy.
- If Ed terminates his taxable year on May 31, 2012, he will have income of \$37,500 and a tax liability of \$8550 for the period Jan. 1 – May 31, 2012, and income of \$52,500 and a tax liability of \$11,970 for the period June 1 – Dec. 31, 2012.

Ed's Taxable Year



- If Ed terminates his taxable year at the commencement of bankruptcy, then the tax liability for the Jan. 1 – May 31, 2012 period becomes a claim against the estate for which Ed is not personally liable (unless the estate's assets are insufficient to pay the liability).
- Ultimately, Ed's election to terminate his taxable year has the potential to reduce the tax that he must pay from post-bankruptcy earnings and assets (from \$20,520 for the full calendar year to \$11,970 for the June 1 – Dec. 31, 2012 period).

Tax Consequences for an Individual in Chapter 7 or Chapter 11

No Short Year Tax Liability

- There is no general rule for this scenario -- specific circumstances must be taken into account in the determination of whether to make the election to terminate the debtor's taxable year.
- For example, if the debtor has tax benefits (e.g., unused deductions, unused credits or an NOL) for the short taxable year, and the debtor is able to use such benefits, it may be beneficial not to make the election. Such tax benefits are available to the debtor in the unbroken year if no election is made. If the debtor has a tax liability for the unbroken year, any deductions, loss or credit can be used to reduce the amount of tax liability that must be satisfied from the debtor's post-bankruptcy earnings and assets.
- Caveat: Under IRC §1398(g), if the election is made, the estate succeeds to any NOL for the short taxable year.



Tax Consequences for an Individual in Chapter 7 or Chapter 11

– Bankruptcy Estate Income Calculations

- IRC §1398(e)(1): “The gross income of the estate for each taxable year shall include the gross income of the debtor to which the estate is entitled under title 11 of the United States Code. The preceding sentence shall not apply to any amount received or accrued by the debtor before the commencement date....”
- IRC §1398(g)(6): “In the case of any asset acquired (other than by sale or exchange) by the estate from the debtor, [the estate shall succeed to] the basis, holding period, and character it had in the hands of the debtor.”



Ed's Bankruptcy Estate



Gross income of Ed's bankruptcy estate includes:

- Income generated by the estate
- Any of Ed's income paid to the estate that was not received or accrued before the commencement of the bankruptcy case.

The bankruptcy estate steps into Ed's shoes with respect to:

- Basis
- Holding period
- Character

Tax Consequences for an Individual in Chapter 7 or Chapter 11

- **Deductions**

- IRC §1398(e)(3): “Except as otherwise provided in this section, the determination of whether or not any amount paid or incurred by the estate – (A) is allowable as a deduction or credit under this chapter, or (B) is wages for purposes of subtitle C, shall be made as if the amount were paid or incurred by the debtor and as if the debtor were still engaged in the trades and businesses, and in the activities, the debtor was engaged in before the commencement of the case.”
- IRC §1398(h)(1):
 - » Administrative expenses are allowed as a deduction to the extent they are not disallowed elsewhere in the IRC.
 - » Fees and charges assessed against the estate under chapter 123 of title 28 of the United States Code are allowed as a deduction to the extent they are not disallowed elsewhere in the IRC.



Ed's Bankruptcy Estate's Deductions

With respect to deductions for Ed's bankruptcy estate,



pretend that the amount was paid by Ed, as if Ed were still engaged in the trade or business (activities) that he was engaged in pre-bankruptcy.

Tax Consequences for an Individual in Chapter 7 or Chapter 11

- **Tax Attributes**

- The bankruptcy estate succeeds to the tax attributes of the debtor:
 - » Net operating loss carryovers;
 - » Carryover of excess charitable contributions;
 - » Recovery of tax benefit items;
 - » Credit carryovers;
 - » Capital loss carryovers;
 - » Basis, holding period and character;
 - » Method of accounting; and
 - » Any other attributes as provided in Regulations.



Tax Consequences for an Individual in Chapter 7 or Chapter 11

- Additional tax attributes provided in Regulations:
 - » Passive activity losses and credits;
 - » Unused at-risk deductions; and
 - » Residence gain exclusion under IRC § 121.
- IRC §1398(j)(2)(A): The bankruptcy estate may carry back NOLs realized during the administration to taxable years prior to the estate's first taxable year. Thus, the estate may obtain a refund of pre-petition taxes that were paid by the debtor.



Ed's Tax Attributes



Tax Consequences for an Individual in Chapter 7 or Chapter 11

- **Estate Property Abandonment**

- Under the Bankruptcy Code, a court may permit or order a trustee to abandon property that is burdensome to the estate or that is of inconsequential value and benefit to the estate.
 - For example, if the estate holds property subject to indebtedness in excess of the property's basis, it is possible that the indebtedness plus the tax liability may exceed the value of the property, once liquidated.
- If property is abandoned, it generally reverts to the debtor.
- There is split authority regarding whether midstream abandonment of property is a sale or other disposition that is taxable to the estate. If it is not taxable to the bankruptcy estate, however, the tax liability is shifted to the debtor.
- If a debtor triggers a foreclosure prior to filing for bankruptcy, the resulting tax is a pre-petition liability that becomes a liability of the bankruptcy estate. If the bankruptcy case and the foreclosure occur in the same calendar year, though, any resulting tax liability is a pre-petition liability only if the debtor makes the election to terminate the taxable year.



Tax Consequences for an Individual in Chapter 7 or Chapter 11

- Conclusion of the bankruptcy case
 - IRC §1398(f)(2): “In the case of a termination of the estate, a transfer (other than by sale or exchange) of an asset from the estate to the debtor shall not be treated as a disposition for purposes of any provision of this title assigning tax consequences to a disposition, and the debtor shall be treated as the estate would be treated with respect to such asset.”
 - IRC §1398(i): The debtor succeeds to any unused tax attributes from the estate.



Ed's Bankruptcy Estate's Tax Attributes



Discharge of Indebtedness

- IRC §61(a)(12): Gross income includes income from discharge of indebtedness.
- IRC §108(a)(1)(A) and (d)(2): Gross income does not include income from discharge of indebtedness if such discharge occurs in a title 11 case.
 - A “title 11 case” means a case under title 11 of the United States Code, but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.



Discharge of Indebtedness

- **Insolvency outside of bankruptcy**
 - IRC §108(a)(1)(B) and (a)(3): Gross income does not include income from the discharge of indebtedness if the discharge occurs when the taxpayer is insolvent. The amount excluded from gross income, however, may not exceed the amount by which the taxpayer is insolvent.
 - Determination of insolvency:
 - IRC §108(d)(3): “Insolvent” is defined as the excess of liabilities over the fair market value of assets, determined on the basis of assets and liabilities immediately before the discharge.
 - Neither the statutory language of IRC §108(d)(3) nor the Committee Reports specify which assets and liabilities are taken into consideration to determine insolvency.



Discharge of Indebtedness

- Change with respect to inclusion of exempt assets
 - Prior to the passage of the Bankruptcy Tax Act, the Tax Court had held that assets exempt from the claims of creditors are not taken into account for purposes of determining insolvency. *Cole v. Comm'r*, 42 B.T.A. 1110 (1940).
 - In 2001, however, the Tax Court held that, under the Bankruptcy Tax Act, assets exempt from the claims of creditors must be counted in determining whether the taxpayer qualifies for the insolvency exception. *Carlson v. Comm'r*, 116 T.C. 87 (2001).
- What about:
 - Contingent liabilities? *Merkel v. Comm'r*, 192 F.3d 844 (9th Cir. 1999).
 - Nonrecourse liabilities? Rev. Rul. 92-53.



Discharge of Indebtedness

- IRC §108(a)(2): The title 11 exclusion takes precedence over the insolvency exclusion, meaning that a taxpayer in a title 11 case will not realize income, even if solvent.



Discharge of Indebtedness

- **Attribute Reduction Rules**

- IRC §108(b)(1): The attribute reduction rules are triggered by the application of the title 11 exception and the insolvency exception.
- IRC §108(d)(8): In a case involving a bankrupt individual to which IRC §1398 applies, the taxpayer is the estate and not the individual debtor for purposes of attribute reduction, except for the purpose of reducing the basis of property transferred by the estate to the debtor.



Discharge of Indebtedness

Basis Reduction

- IRC §108(b)(5): The taxpayer may elect first to reduce the basis of depreciable property prior to other attributes.
 - IRC §1017(b)(3)(D) and (E): The taxpayer may also extend the election to real property held for sale to customers in the ordinary course of business and to stock of a subsidiary if the subsidiary consents to reduce the basis of its depreciable property.
 - IRC §1017(b)(3)(C): A partner may treat a partnership interest as depreciable property to the extent of her proportionate interest in the depreciable property of the partnership if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.



Discharge of Indebtedness

- IRC §108(b)(2): Discharge of indebtedness income excluded by the title 11 and the insolvency exceptions is applied to reduce tax attributes in the following order:
 - Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.
 - Any carryover to or from the taxable year of the discharge of an amount representing the amount allowable as a general business credit under IRC §38.



Discharge of Indebtedness

- The amount of the minimum tax credit available under IRC §53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.
- Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year.
- Basis as provided in IRC §1017.
- Any passive activity loss or credit carryover of the taxpayer under IRC §469(b) from the taxable year of the discharge.
- Any foreign tax credit carryover to or from the taxable year of the discharge.



Discharge of Indebtedness

- **Notes on Attribute Reductions**

- The reduction of attributes is made on a dollar-for-dollar basis, except for the reduction of credit carryovers, which is made on the basis of 33 1/3 cents for each dollar excluded from income under IRC §108(a).
- IRC §108(b)(4)(A): The reduction in tax attributes is made after the determination of tax for the taxable year of the discharge. Accordingly, tax attributes arising in or carried to the taxable year of the discharge may be used to reduce income or tax for the taxable year of the discharge prior to reduction.



Discharge of Indebtedness

- Basis Reduction Rules
 - The reduction is treated as a deduction for depreciation, even if property is not depreciable, and subsequent disposition could give rise to IRC §1245 or IRC §1250 recapture.
 - Basis reductions take effect on the first day of the taxable year following the year in which discharge takes place.



Discharge of Indebtedness

- The order of properties subject to basis reduction is addressed in the Regulations (§1.1017-1(a)):
 - Real property used in a trade or business or held for investment, other than real property described in IRC §1221(1) that secured the discharged indebtedness immediately before the discharge.
 - Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the discharged indebtedness immediately before the discharge.
 - Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable and real property described in IRC §1221(1).
 - Inventory, accounts receivable, notes receivable and real property described in IRC §1221(1).
 - Property not used in a trade or business or held for investment.



Discharge of Indebtedness

Other non-bankruptcy options under IRC §108:

- Qualified real property business indebtedness
- Qualified principal residence indebtedness
- Qualified farm indebtedness
- Deferral of income from cancellation of indebtedness under IRC §108(i) – calendar years 2009 and 2010



Discharge of Indebtedness

- Qualified Real Property Business Indebtedness
 - Under IRC §108(a)(1)(D), there is an exclusion from gross income for discharged qualified real property business indebtedness of taxpayers other than C corporations. Generally, the effect of the exclusion is to give a taxpayer who is neither insolvent nor in bankruptcy an election to reduce the basis of depreciable real property by the amount of discharged qualified real property business indebtedness. Such election is in lieu of recognizing income.



Discharge of Indebtedness

- Qualified Principal Residence Indebtedness
 - Under IRC §108(a)(1)(E), the discharge of qualified principal residence indebtedness prior to January 1, 2013, is excluded from gross income.



Discharge of Indebtedness

- Qualified Farm Indebtedness
 - Under IRC §108(a)(1)(C), there is an exclusion from gross income for the discharge of qualified farm indebtedness. Essentially, this exclusion allows a taxpayer who is in the business of farming to reduce tax attributes instead of recognizing income from discharge of indebtedness.



Discharge of Indebtedness

- Deferral of Income from Cancellation of Indebtedness
 - Under IRC §108(i), a deferral of income recognition was provided for income arising from the “reacquisition” of an “applicable debt instrument” during calendar year 2009 or 2010.
 - Such income is deferred for either four or five years and then included ratably over a five-year period.



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