

Analysis of an S-Corporation and C-Corporation Tax Return to Evaluate Disposable Income and Asset Evaluation of a Debtor

To review the Debtor's interest in an S-Corporation, Bankruptcy Trustees must review the S-Corporation tax returns (Federal Form 1120S). A Debtor's ownership in an S-Corporation often is the income producing entity from which the Debtor generates income. Trustees must evaluate the Debtor's best efforts in directing income into the plan for the benefit of Creditors pursuant to 11 USC Section 1322 (d) and 1325 (b)(1)(B). Additionally, the S-Corporation may have title to valuable assets that the Trustee must consider to evaluate the best interests of Creditors test pursuant to 11. USC Section 1325 (a)(4).

NOTE: There are generally two major corporate entities the Trustee will encounter; S-Corporations and C-Corporations. For bankruptcy evaluations of the Debtor's income and assets, there is no real difference. From a legal and tax perspective, the difference is as follows:

S-Corporations pay no corporate income tax. The net corporate income is reported on the S-Corporation federal tax return. The income is also reported on a pro-rata basis (percentage of stock ownership) on the corporate shareholders' personal return. An S-Corporation, similar to partnerships, is deemed a "pass thru entity" for tax purposes since income tax is paid by the corporate shareholders and not the corporation. S-Corporations are generally closely held corporations (family controlled), mom-pop operations (husband and wife), or single shareholder (sole individual ownership). While S-Corporations provide little tax benefits, the corporate entity provides state law limited liability protection for the shareholder-owners. Additionally, operating as a corporate entity often offers marketing advantages as large corporations and government agencies prefer to do business with a corporation instead of non-corporate entities such as partnerships and sole proprietors. S-Corporations need only file annual federal forms in lieu of the quarterly forms required of C-Corporations. S-Corporations remain liable for payment of payroll taxes and all state licensing requirements.

C-Corporations are sometimes called "regular corporations". These entities are large corporate entities (Fortune 500 firms) with complex legal and tax structures. If the corporate stock is publicly traded, the Trustee can quickly value the Debtor's interest by multiplying the Debtor's shares by the public trading price on the date the Debtor filed for bankruptcy. It is unlikely the Debtor has any type of management control of a public company based on a small number of shares. Although rare, the Trustee may encounter a Debtor who has a interest in a closely held or single shareholder C-Corporation. C-Corporations pay

corporate income tax. If the Debtor has formed a C-Corporation it is likely the Debtor is trying to take advantage of the lower corporate tax rates versus individual tax rates. Trustees must take care to evaluate the income and assets of these entities as shareholders often leave income and assets inside the corporate entity to take advantage of the lower corporate tax rate. C-Corporations offer the Debtor-shareholder limited liability protection, but the tax reporting requirements are quarterly. C-Corporations remain liable for payroll taxes, state and local taxes, and all state licensing requirements.

C-Corporations file annual federal tax form 1120. For bankruptcy evaluation purposes there is little difference in evaluating a S-Corporation or C-Corporation to determine the Debtor's income and assets.

Evaluating an S-Corporation Tax Return:

Check the S-Corporation name to verify the entity is incorporated. S-Corporations (and C-Corporations) can only be formed pursuant to state law. A firm must incorporate by filing papers with the proper state entity, usually the Secretary of State (or State Commerce Department, depending on jurisdiction). Incorporation information can often be verified via the internet as most states now have these records available on-line.

National Internet Resource Site: One useful site for accessing incorporation information, property records, and other public data is: *searchsystems.net*. The site has hyper-links to public records in all fifty states. The majority of the information can be accessed free of charge. Note: To access incorporation information, use the sub headings under "Corporations".

The purpose of verifying incorporation is to determine whether the Debtor has a corporation or is really a sole proprietor acting as a corporation. Sometimes Debtors allow their corporate charter to lapse (failing to file annually and pay state franchise fee). If the corporate charter has lapsed, the Debtor is only a sole proprietor for bankruptcy evaluation purposes (or partner in an unincorporated partnership if the Debtor was only one of two or more shareholders). If incorporation is verified, the Trustee must evaluate the net asset value of the corporation and said value must be placed on bankruptcy petition schedule B (line 12). If the corporation is no longer incorporated, the Trustee must individually value the assets used in the business and make sure that the individual assets are listed on Schedule B.

Note: Should the Debtor list the corporate name on the bankruptcy petition (under "all other names used by the Debtor")? Since corporations cannot file a Chapter 13 petition pursuant to 11 USC Section 109 (e), the corporate name should not be on the petition as it may mislead Creditors of the corporation in believing the corporation has filed for bankruptcy. Even if the corporation is defunct and the Debtor has personal liability for some corporate debt, the

corporate name should not be on the petition. Corporations may file Chapter 7 to liquidate the corporation and put corporate Creditors on notice. Placing the name of an incorporated entity or prior incorporated entity on the Chapter 13 petition is not proper.

Corporations are not eligible for Chapter 13 Bankruptcy pursuant to 11 USC Section 109 (e), but Bankruptcy Trustees control the stock of the corporation as the stock is an asset of the bankruptcy estate pursuant to 11 USC Section 541. Since the stock is an asset of the estate, the Trustee stands in place of the Debtor-shareholder, and as a shareholder, the Trustee has the right to inspect corporate records, bank statements, insurance documents, and all other relevant data deemed necessary by the Trustee to evaluate the Debtor's best efforts and the Creditors best interest pursuant to 11 USC Sections 1322 (d), 1325(b)(1)(B), and 1325 (a)(4). As a fiduciary, the Trustee is empowered by statute to review all business interests of the Debtor pursuant to 11 USC Sections 1106 (a)(3), 1106 (a)(4) and 1302 (c). The Debtor is required to cooperate with the Trustee in supplying all requested records pursuant to 11 USC Section 521(3) and 521(4), and Bankruptcy Procedural Rule 4002(3) and 4002(4).

If the Debtor does not cooperate with the Trustee, the Trustee should motion the Court to dismiss the case with sanctions pursuant to 11 USC 109 (g)(1). The motion should state that the Debtor has refused to cooperate with the Trustee therefore the Trustee cannot recommend confirmation as the Trustee cannot conduct the confirmation tests required by 11 USC Section 1325. Even if the Debtor is paying, the Trustee should not recommend confirmation if the Debtor has not been honest and forthcoming in providing requested information.. Although the Debtor may make payments to the Trustee, said payments do not excuse the Debtor from being honest and forthcoming, See In Re Alt, 305 F.3d 413 (Sixth Circuit, 2002).

Even if the Debtor proposes to pay all creditors 100% in a five year plan, the Trustee should not recommend confirmation without reviewing business records of the Debtor. Pursuant to 11 USC Section 1325 (b)(1)(B), the Debtor must supply all disposable income into the plan for a minimum three year period. By reviewing the Debtor's business records, the Trustee may determine the Debtor can complete the plan in three years and there is no need for Creditors to wait five years for payment (the bankruptcy code only allows five year plans for "cause"). Note: Trustees must take guard of Debtors who propose a 100% plan and then seek to modify the plan to a lowered percentage less than a year after obtaining confirmation. The Debtor is betting that given the volume of cases, the Trustee may not conduct a full business review with a case proposing to pay 100% prior to confirmation and then a modification to a lowered percentage can quietly slide through the system. The Trustee must take care to conduct a full business review of all business cases prior to confirmation to evaluate whether a case proposing a 100% unsecured dividend can actually fund a 100% dividend.

If the Debtor proposes to continue to operate an incorporated entity, bankruptcy Trustees must be on guard that the Debtor is not attempting to pay any corporate debt through the plan. Even if the Debtor has personal liability on some corporate debt, legally, the personal

liability does not attach until the corporation is defunct and not able to pay. If the Debtor is proposing to make Chapter 13 plan payments from the Debtor's interest in future corporate earnings than the corporation is not defunct and there is no personal liability. Corporate debt should be paid by the corporation as long as the corporation is a going concern.

Note: In a corporation with one shareholder, or a closed corporation with a limited number of shareholders, the Debtor- shareholder often must sign a personal guarantee to allow the corporation to obtain financing. The personal guarantee makes the shareholder personally liable for the bank loan. However, the bank loan should only be scheduled on the Debtor's Chapter 13 schedules if the corporation is not a going concern.

Note: The Internal Revenue Service has authority to hold shareholders-owners to be responsible parties for the payment of trust fund taxes (payroll taxes). Even if the corporation is a going concern, the IRS can seek payment from the Debtor through the Chapter 13 plan. However, the IRS cannot seek payment of trust fund taxes in a Chapter 13 plan until the IRS has officially assessed the tax against the Debtor personally.

A corporation's net worth (the amount which should be reflected on Schedule B of the bankruptcy petition) can be found on the 1120S tax return balance sheet (Schedule L of the return).

Corporate net worth is capital stock, additional paid in capital, and retained earnings (the sum of lines 22, 23, and 24 of Schedule L of the 1120S tax return). Corporate net worth is not cash, corporate net worth is the equity remaining in the corporation if assets were liquidated and all liabilities were paid, thus this amount must be shown on Schedule B of the bankruptcy petition and used to calculate the best interest of creditors test pursuant to 11 USC 1325 (a)(4). Debtor's counsel often try to state the corporate net worth as zero. This is not proper unless the corporate net worth is negative.

Some tax preparers fail to complete the balance sheet section of the 1120S return. If the balance sheet is blank, the Trustee should enter an agreed order with the Debtor to have a third party Certified Public Accountant (CPA) review the Debtor's records and prepare a balance sheet.

Note: The Trustee should always review the qualifications of the CPA before approving an agreed entry for the CPA's services. The CPA should perform a review of the Debtor's records and work independently of the Debtor in preparing the balance sheet. Debtor's often try to have the CPA prepare a

“compilation” of the financial statements. A “compliance” is merely taking what the Debtor says (without proof) and placing said information in financial statement form. The CPA should be appointed as a professional pursuant to 11 USC Section 327 and paid by the Debtor’s bankruptcy estate as an administrative expense pursuant to 11 USC Section 503 (b).

Note: S-Corporation returns have K-1 schedules which state the Debtor’s percentage ownership in the corporation. Thus, if the Debtor only owns 50% of the corporation, only one half of the S-Corporation’s ordinary income (line 21 of the S-Corporation return) and only one half of the net asset value of the corporation can be allocated to the Debtor for bankruptcy evaluation of assets and income. When evaluating income, the Trustee should review K-1 schedules to see if the other 50% can be allocated to the Debtor’s spouse, or significant other living with the Debtor, to determine if Bankruptcy Petition Schedule I reflects all household income.

Example of Imputed Income of Debtor from S-Corporation Return
 (example returns attached)

Line 21, Ordinary Net Income of Debtor \$20,000
 (Assume Debtor owns 100% of Corporation)

Note: Same number should appear on Debtor's individual
 1040 Federal Return, Schedule E.

Note: Check K-1 Schedule, if Debtor only owns 50% of
 Corporation only half of ordinary income should
 appear on Debtor's individual 1040 Federal
 Return, Schedule E.

Line 7, Officer Compensation, check the 1099 returns of
 the corporation to see if Debtor pays himself for
 serving as officer of corporation. \$10,000

Line 8, Salary, check the W-2 returns of the corporation
 to see if the Debtor pays himself a wage as an
 employee of the corporation. \$50,000

Line 14A, Depreciation, depreciation is usually not
 a current cash outlay but is the tax recapture of
 a prior cash outlay. Add it back and place the
 burden on the Debtor to prove the expense is
 a current cash outlay. \$10,000

Line 17, Pension and profit sharing, check the W-2 returns of
 the corporation to see if the Debtor participates in
 the corporate pension program. Remember that if the
 Debtor does not place the money in a pension fund, there
 will be tax consequences as the funds will no longer be
 tax deferred. Assume a 35% tax bracket (federal and state).
 (\$15,000 - 35% taxes) \$ 9,750

Debtor's Imputed Income \$99,750

Plus: Add Income of Debtor's Spouse or Significant
 Other who resides with Debtor (Check W-2s and
 1099s for income of related parties!) \$50,000

Total Annual Household Income \$149,750

Divided by 12 months for monthly income
 to be reported on Bankruptcy Petition
 Schedule I (\$149,750 / 12 months) \$ 12,479