Concurrent Session

Respecting the Tax Laws: Pre-Filing Tax Planning and Advanced Tax Issues

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RESPECTING THE TAX LAWS:
Pre-filing Tax Planning and Advanced Tax Issues

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INTRODUCTION

Consumer bankruptcy counsel must recognize the numerous opportunities for pre-filing tax planning in order to maximize the benefits of the client's bankruptcy filing. As an initial matter, counsel must verify the debtor's existing tax compliance since, under current law, basic tax return compliance is required to institute and maintain a bankruptcy filing. Next, counsel must identify applicable tax issues to provide the client with informed consent related to discharge of any tax liability and other tax planning opportunities. Finally, counsel must develop a plan to capitalize on opportunities for any tax liability or other tax related savings to the client.

I. Pre-filing Tax Planning For an Individual Chapter 7 Case

A. Election to End Tax Year Under 26 U.S.C. § 1398

1. The Election. If the debtor is an individual debtor in a chapter 7 or 11 case, the debtor may be able to elect to close the debtor's tax year for the year in which the bankruptcy petition is filed, as of the day before the date on which the bankruptcy case commences. If the debtor makes the election, the debtor's tax year is divided into 2 short tax years of less than 12 months each. The first year ends on the day before the commencement date and the second year begins on the commencement date. If the election is made, the debtor's federal income tax liability for the first short tax year becomes an allowable claim against the bankruptcy estate as a claim arising before the bankruptcy filing. The tax liability for the first short tax year, which is not subject to discharge under the Bankruptcy Code, can be collected by the IRS from the bankruptcy estate.

2. Effect of No Election. If the debtor does not make an election to end the tax year, the commencement of the bankruptcy case does not affect the debtor's tax year. Also, no part of the debtor's income tax liability for the year in which the bankruptcy case commences can be collected by the IRS from the bankruptcy estate. The debtor cannot make a short-year election if the debtor has no assets in the bankruptcy estate other than exempt property. 26 U.S.C. § 1398(d)(2)(C).

3. Making the Election. The debtor can elect to end the debtor's tax year by filing a return on Form 1040 for the first short tax year. The return must be filed on or before the 15th day of the fourth full month after the end of that first tax year.

4. Election by Debtor's Spouse. If the debtor is married, the debtor's spouse may join in the election to end the tax year. If the debtor and spouse make a joint election, the debtor **must** file a joint return for the first short tax year. 26 U.S.C. § 1398(d)(2)(B). The debtor must make these choices by the due date for filing the return for the first short tax year. Once the choice is made, it cannot be revoked for the first year. However, the choice does not mean the debtor and the spouse must file a joint return for the second short tax year.

5. Later Bankruptcy of Spouse. If the debtor's spouse files for bankruptcy later in the same year, he or she may also choose to end his or her tax year, regardless of whether he or she joined in the choice to end the debtor's tax year. Because each of them has a separate bankruptcy estate, one or both of them may have 3 short tax years in the same calendar year. If the debtor's spouse joined in the debtor's choice, or if the debtor had not made the choice to end the tax year, the debtor can join in the spouse's choice. But if the debtor made an election and the spouse did not join in the election, the debtor cannot join in the spouse's later election. This is because the debtor and the spouse have different tax years. The debtor does not have a tax year ending the day before the spouse's filing for bankruptcy, and the debtor cannot file a joint return for a year ending on the day before the spouse's filing of bankruptcy.

B. Planning for Exclusion of COD Income

1. In general, under Section 61 of the Internal Revenue Code ("IRC"), the cancellation of indebtedness is included in the debtor's gross income (often referred to as COD income). However, if the cancellation of indebtedness "occurs in a Title 11 case," IRC § 108(a)(1)(A) excludes such COD income from the debtor's gross income, but at a cost. That cost is the reduction of the debtor's tax attributes pursuant to IRC § 108(b). See attached § 108 Flowchart.

   As a practice note, it is important to understand the level at which the § 108 analysis is performed. For a Subchapter S corporation, the analysis is at the entity level. However, for a partnership, the analysis is at the partner level.

2. If a debtor excludes COD income under IRC § 108(a)(1)(A), then the debtor is required to reduce the following tax attributes, by the amount of COD income excluded, in the following order:

   a. Net operating losses ("NOLs") for the year of the discharge and NOL carryovers from prior years;

   b. General business tax credits under IRC § 38 at the rate of 33 1/3 cents of credit per dollar of COD income;

c. Minimum tax credits under IRC § 53(b) available as of the beginning of the year following the year in which the debt was discharged at the rate of 33 1/3 cents of credit per dollar of COD income;

d. Capital loss for the year of discharge and capital loss carryovers from prior years;

e. Basis of the debtor's property;

f. Passive activity loss and credit carryovers under IRC § 469 from the year in which the debt was discharged at the rate of one dollar of loss and 33 1/3 cents of credit per dollar of COD income; and

g. Foreign tax credit carryovers to or from the year in which the debt is discharged, at the rate of 33 1/3 cents of credit per dollar of COD income.

3. The reduction of the basis of the debtor's property pursuant to IRC § 108(b) is governed under IRC § 1017 and its regulations. Treasury regulation 1.1017-1(a) provides that the basis of the debtor's property shall be reduced in the following order:

a. Real property used in a trade or business or held for investment (other than real property described in section 1221(1)) that secured the discharged debt immediately before the discharge;

b. Personal property used in a trade or business or held for investment (other than inventory, accounts receivable, and notes receivable) that secured the debt immediately before the discharge;

c. Other property used in a trade or business or held for investment (other than real property described in section 1221(1), inventory, accounts receivable, and notes receivable);

d. Real property described in section 1221(1), inventory, accounts receivable, and notes receivable; and

e. Property not used in a trade or business nor held for investment.

IRC § 1017(b)(2) (often referred to as the "Liability Stop Rule") provides that under the normal asset-reduction rule of IRC § 108(b)(2), the reduction in the debtor's property's basis cannot reduce the debtor's aggregate remaining property basis below the amount of the debtor's debt immediately after the discharge.

4. In general, the reduction of attributes does not occur until after the end of the debtor's tax year in which the debtor's indebtedness is discharged. IRC § 108(b)(4)(A) provides that "[t]he reductions. . .shall be made after the determination of the tax. . .for the taxable year of the discharge." Similarly, IRC § 1017(a) provides that the debtor's basis shall be reduced "at the beginning of the taxable year following the taxable year in which the discharge occurs."

5. Under IRC § 108(b)(4)(B), the reduction to NOLs and capital loses are made (i) to the loss in the year of discharge and (ii) to the carryovers in such taxable year in the order of the taxable years from which each such carryover arose. Under IRC § 108(b)(4)(C), the reduction to the general business credits and foreign tax credits are made in the order in which the carryovers are taken into account in the taxable year of discharge.

C. Planning for Net Operating Losses

1. Net Operating Losses ("NOL") can be incurred by any entity under the Internal Revenue Code. The Internal Revenue Code allows for the application of these losses to both prior and subsequent tax years to the year in which the loss occurs. As such, certain issues have arisen in bankruptcy proceedings of which the practitioner should be aware.

a. NOL's are created when the taxpayer's deductable business expenses for a given year exceed the net income for that year. (26 U.S.C. §172(c)).

b. Once the NOL has been incurred, the taxpayer has the opportunity to apply the NOL to both prior and subsequent years. The NOL may be applied first to the prior two (2) years tax returns (earliest return first), and then, to the extent a NOL still exists, to the subsequent 20 years tax returns. (26 U.S.C. §172(b)(1)(A)).

c. Alternatively, the IRC allows the taxpayer to forego the "carryback" period, and instead, elect to apply all NOL amounts to offset future income. (26 U.S.C. §172(b)(3)).

d. Once the election regarding "carryback" and "carry forward" has been made (i.e. whether to waive the carryback provision as noted in 3 above) the determination is irrevocable pursuant to the Internal Revenue Code. (26 U.S.C. §172(b)(3)).

2. The Bankruptcy Code Provides Broad Powers to the Trustee

a. The Trustee in bankruptcy is provided with broad powers under 11 U.S.C. §§ 548 and 549 to avoid transfers and obligations for the benefit of the bankruptcy estate and creditors.

b. These powers are generally seen as being geared toward protecting the rights of the creditors. They have been read so broadly as to even allow a Trustee to avoid transfers which are considered to be irrevocable under state law. (See *In re Lewis*, 45 B.R. 27 (W.D. Mo. 1984)).

c. As a result, the issue has been raised whether a Bankruptcy Trustee, in seeking to protect the bankruptcy estate, may avoid the pre-petition and/or post-petition irrevocable election of bankrupt to not seek the "carryback" of the NOL in prior years.

d. The issue is of importance because, pursuant to 26 U.S.C. 1398(g)(1), the estate succeeds to the taxpayers NOL, and upon termination of the bankruptcy, the debtor succeeds to the bankruptcy estate's tax attributes, including the NOL (26 U.S.C. §1398(i)).

e. The implication, therefore is, that a debtor, aware of the impending bankruptcy proceedings, or even during the course of the proceedings, may elect to only carry forward the losses, thereby depriving the bankruptcy estate of tax refunds to which it might be entitled from a carryback of the NOL.

3. *In re Russell*, 927 F.2d 413 (8th Cir.1991)

a. This case addressed this issue and held that a Bankruptcy Trustee may seek to avoid a debtor's irrevocable election to carry forward NOL's. Effectively, the Court semantically (and substantively) held that the broad avoidance powers granted to the trustee under the Bankruptcy Code permitted the avoidance of the election, even though the election was "irrevocable". The Court determined the Trustee was not revoking the election, but rather, was avoiding the election.

b. The *Russell* court further held that the Trustee, having submitted Amended Tax Returns which attempted to applied the avoided carryback NOL, did not constitute an action to revoke the election, but rather to seek a refund.

c. The Trustee must still prove the four (4) elements of a §549 claim, which are:

i. The action complained of takes place after the bankruptcy case begins.

ii. The property of the bankruptcy estate must be involved. [Practice note: it must be remembered that the property is not the potential refund from the prior years, but rather, the NOL, which is being carried forward, and is sought to be carried back by the trustee].

iii. The debtor transferred the property. [Practice note: The Bankruptcy Code defines a transfer to include any "...mode, direct or indirect, absolute or conditional, voluntary or involuntary, or disposing of or parting with - (i) property; or (ii) an interest in property:... (11 U.S.C. §101(54)(D)). The Court held that the debtor "disposed" of the estate's right to the NOL, and thus had transferred property of the estate].

iv. Did the Debtor make the election in the ordinary course of business.

d. The trustee must still prove the four (4) elements of a §548 claim. While the first three elements are generally the same as a §549 claim, the fourth element, which is whether the debtor made the election with the intent to hinder, delay, or defraud any existing creditors still needs to be addressed.

4. *In re Fieler*, 218 F.3d 948 (9th Cir. 2000)

a. In this case, the 9th Circuit Court of Appeals was also asked to review the issue of the "revocation" of the election to carry forward the NOL. Again, holding that the elements of 11 U.S.C. § 548 had been met (note that this Court did not specifically address the issue raised above regarding the "intent" to hinder, delay or defraud existing creditors).

b. The Court also noted that while the *Russell* Court (above) and the Court in *In re Prudential Lines, Inc.*, 928 F.2d 565 (2d Cir. 1991) had held that the NOL itself was property of the estate, this court indicated that the NOL was not the "property of the estate" needed to meet the element of the claim, but rather, the potential tax refund was the "property of the estate".

D. Tax Refunds as Property of the Estate

1. *Araj v. Kohut* (*In re Araj),* 371 B.R. 240 (E.D. Mich. 2007) (Tax refund attributable to pre-petition portion of year of the bankruptcy filing constitutes property of the estate subject to pro-ration.)

2. *In re Marble*, Ch. 7 Case No. 09-40146 (Bankr. E.D. Mich. December 28, 2009) *rev'd on other grounds*, 2010 U.S. Dist. LEXIS 81881 (E.D. Mich. August 12, 2010) (Judge Shapero concluded that (1) there is a rebuttable presumption that each debtor-spouse has an equal, one-half property interest in the tax refund; (2) such presumption may, however, be rebutted by evidence of debtor-spouses' financial history or fiscal practices that demonstrate intentions contrary to equal ownership i.e., individual accounts and history of filing separate tax returns.)

E. Discharge of Taxes in Chapter 7

1. Chapter 7

a. There is no discharge for a corporation under Chapter 7.

b. Individuals are discharged from all pre-petition taxes except those excepted from discharge under § 523:which are:

i. Priority taxes under § 507(a)(3) and § 507(a)(8);

ii. Trust fund taxes are never dischargeable;

iii. Tax for which a return or equivalent report or notice, if due was not filed or given; was filed or given within two years of the petition date; or

iv. With respect to which the debtor made a fraudulent return or attempted to evade in any manner (evasion of payment).

c. Tolling: § 507 time frames are tolled by a prior bankruptcy or appeal plus an additional 90 days.

d. Debt incurred to pay a priority tax not discharged under § 523(a)(14) and (14A).

F. Is the Client's Property Encumbered by a Tax Lien?

1. It is important to determine whether a tax lien has been filed to secure an outstanding tax liability for a number of reasons. First, 11 U.S.C. § 522(c)(2)(B) provides that property otherwise exempt is liable for a tax secured by a tax lien, notice of which is properly filed. Second, a discharge under 11 U.S.C. § 727 does not discharge the "in rem" liability established by a tax lien. Third, for purposes of determining the existence and valuation of a secured claim within the meaning of 11 U.S.C. § 506(a). Finally, for purposes of distribution of property of the estate under 11 U.S.C. § 724(b).

2. Federal Tax Liens - The Internal Revenue Code and Michigan's Uniform Federal Lien Registration Act (Uniform Act) set forth the rules that govern where the IRS must file a notice of a federal tax lien. The Uniform Act establishes the following rules for where the IRS must file a notice of a federal lien:

a. Real Property. A notice of a federal lien on real property must be filed in the office of the register of deeds in the county in which the real property is located.

b. Personal Property. In the case of personal property, the notice of federal lien must be filed as follows:

- If the taxpayer or debtor is a corporation or a partnership whose principal executive office is in Michigan, then the notice of federal lien must be filed in the Office of the Secretary of State.

c. In all other cases, the notice of the federal lien must be filed in the office of the register of deeds of the county in which the debtor/taxpayer "resides" at the time the notice of lien is filed.

d. State Tax Liens - The rules that govern where to file a notice of a state tax lien are primarily set forth in the Michigan State Tax Lien Registration Act. A notice of a state tax lien on real property must be filed in the office of the register of deeds in the county where the real property is located. In the case of personal property, a notice of a state tax lien must be filed (1) in the Office of the Secretary of State if the taxpayer is a corporation or "partnership" whose principal executive office is in Michigan and, (2) in all other cases, in the office of the register of deeds in the county in which the taxpayer resides.

II. Pre-Filing Tax Planning for a Chapter 13

A. Debtor's Pre-petition Tax Returns Must be Filed or be Ready to be Filed

1. Section 1308(a) of the Bankruptcy Code requires Chapter 13 debtors to file all required tax returns for tax periods ending within 4 years of the debtor's bankruptcy filing. All such federal tax returns must be filed with the IRS before the date first set for the first meeting of creditors held under Section 341(a). The debtor may request the trustee to hold the meeting open for an additional 120 days to enable the debtor to file the returns (or until the day the returns are due under an automatic IRS extension, if later). 11 U.S.C. § 1308(b)(1). After notice and hearing, the bankruptcy court may extend the period for another 30 days. Failure to timely file the returns can prevent confirmation of a chapter 13 plan and result in either dismissal of the chapter 13 case or conversion of the case to a chapter 7 case.

2. Chapter 13 trustees may require the debtor to submit copies of transcripts of the debtor's return as proof of filing. The debtor can request free transcripts of the debtor's income tax returns by filing Form 4506-T with the IRS or by placing a request on the IRS's free Automated Delivery Service (ADS), available by calling 1-800-829-1040. If requested through ADS, the transcript will be mailed to the debtor's most current address according to the IRS's records. Transcripts requested using Form 4506-T may be mailed to any address, including to the attention of the trustee in the debtor's bankruptcy case. Transcripts are normally mailed within 10 to 15 days of receipt of the request by the IRS. A transcript contains most of the information on the debtor's filed return, but it is not a copy of the return. To request a copy of the debtor's filed return, use Form 4506. It may take up to 60 days for the IRS to provide the copies after receipt of the debtor's request, and there is a fee of $57.00 per tax return for copies of the returns.

B. The Debtor's Chapter 13 Bankruptcy Estate is not Treated as a Separate Entity for Tax Purposes.

C. What Constitutes a Pre-petition Claim within the Meaning of 11 U.S.C. § 1305?

1. *In re Michael George Turner*, 420 B.R. 711 (Bankr. E.D. Mich. 2009) (In a chapter 13 case, whether a tax claim is treated as pre-petition or post-petition is controlled by 11 U.S.C. § 1305(a). Under that section, taxes "become payable" when the tax is ascertainable by the taxing authority, that is, when the return is filed).

D. Discharge of Taxes in Chapter 13

1. Taxes are not consumer debt. *IRS v. Westberry (In Re Westberry)*, 215 F.3d 589 (6th Cir. 2000).

2. Unfiled or fraudulent returns no longer dischargeable - no super discharge.

3. Discharge generally follows the Chapter 7 discharge rules. A Chapter 13 debtor will not be eligible for a discharge unless all priority pre-petition income tax liabilities have been paid in full through the debtor's plan of reorganization. However, 11 U.S.C. § 1322(a)(2) allows the debtor to request that the taxing authority agree to different treatment of the claim.

4. It is within the IRS's discretion whether or not to file a proof of claim for post-petition income tax liabilities. It is not uncommon for the IRS to file an amended proof of claim for post-petition liabilities that arise during the life of the debtor's plan. This can affect the debtor's ability to successfully complete their plan of reorganization and, therefore, careful planning must take place where post-petition tax liability is expected to occur. The State of Michigan as a rule does not file a proof of claim for post-petition taxes.

5. A debtor who knows that they will have income tax liability should be advised that if the liability has yet to be ascertained by the taxing authority (petition is filed before April 15, or October 15 if a valid extension has been granted) that liability may have to be paid directly by the debtor outside the plan.

6. Although the taxing authorities can not technically attempt to collect from the debtor during the time that the automatic stay is in place, the debtor can make payment arrangements with the taxing authorities, and use this re-payment as a line item expense on their schedule J. In the case of a debtor who can not afford to satisfy the entire amount of IRS debt over the life of their plan (if that debtor must also cure mortgage arrearage, property tax arrearage, and provide for ongoing monthly mortgage installments) it may be wise to file the bankruptcy petition before the tax debt is ascertained by the taxing authorities.

7. A debtor who knows that they will have income tax liability can also wait to file after the taxes have become due and owing (after April 15, or October 15 if a valid extension has been granted). By waiting to file at a time when this debt is truly pre-petition, the debtor can be assured that the IRS will file a proof of claim for the liability. The priority portion of that debt must be paid in full in order for the debtor to receive a discharge in Chapter 13.

III. Pre-Filing Planning for Individual Chapter 11 Filing

A. Election to End Tax Year Under 26 U.S.C. § 1398 is Available in Chapter 11 Cases

B. Debtor is Responsible for Two (2) Tax Returns in a Chapter 11 Case

1. In chapter 11, the debtor often remains in control of the assets as a "debtor-in-possession" and acts as the bankruptcy trustee. In a chapter 11 case, the debtor must file both a Form 1040 and a Form 1041 for the bankruptcy estate (if the estate meets the return filing requirements). For cases filed after October 16, 2005, earnings from services performed by an individual debtor after the commencement of the chapter 11 case are property of the bankruptcy estate under 11 U.S.C. § 1115. Under IRC § 1398(e)(1), gross income of the estate includes income that the debtor earns for services performed after the bankruptcy petition date and should be included on the bankruptcy estate's Form 1041 tax return.

2. If a chapter 11 case is converted to a chapter 7 case, 11 U.S.C. § 1115 does not apply after conversion and:

a. Earnings from post-conversion services will be taxed to the debtor, rather than the estate, and

b. The property of the chapter 11 estate will become property of the chapter 7 estate. Any income on this property will be taxed to the estate even if the income is realized after the conversion to chapter 7.

c. If the chapter 11 case is dismissed, the debtor is treated as if the bankruptcy case had never been filed and as if no bankruptcy estate had been created.

C. Discharge of Taxes in Chapter 11

1. Under § 1141(d)(6)(B), a Plan of Reorganization no longer discharges a corporate debtor from a tax for which a fraudulent return was filed or which the debtor attempted to evade or defeat in any manner (evasion of payment).

2. Failure to timely pay post-petition taxes is a "cause" for conversion or dismissal under § 1112(b)(4)(I).

3. Individual no longer automatically discharged upon confirmation. Under § 1141(d)(5), an individual debtor must request a discharge after completion of all payments under the plan.

IV. Post-Filing Tax Issues

A. Debtor Must Remain Tax Compliant

1. Section 521(j)(1) of the Bankruptcy Code provides that if the debtor does not file a tax return that becomes due after the commencement of the bankruptcy case, or obtain an extension for filing the return before the due date, the taxing authority may request that the court either dismiss the case or convert the case to a case under another chapter of the Bankruptcy Code. If the debtor does not file the required return or obtain an extension within 90 days after the request is made, the bankruptcy court must dismiss or convert the case. 11 U.S.C. § 521(j)(2).

V. Miscellaneous Tax Issues

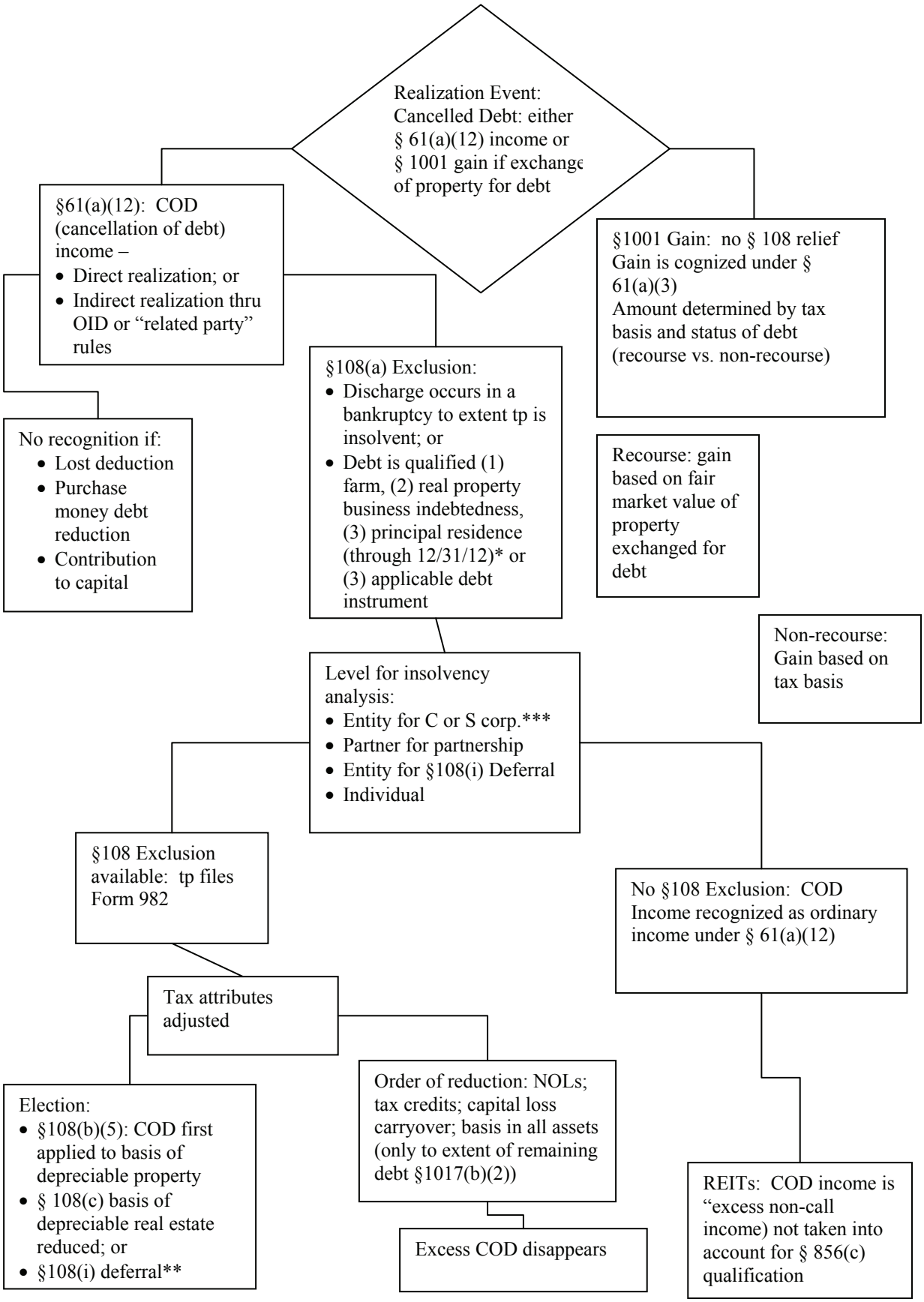
A. Mortgage Forgiveness Debt Relief Act of 2007

1. The Internal Revenue Code allows taxpayers to exclude canceled debt from income if it is qualified principal residence indebtedness. Qualified principal residence indebtedness is any mortgage taken out to buy, build, or substantially improve the taxpayer's main home. It also must be secured by the main home. Qualified principal residence indebtedness also includes any debt secured by the main home that was used to refinance a mortgage taken out to buy, build, or substantially improve the main home, but only up to the amount of the old mortgage principal just before the refinancing.

2. The maximum amount that can be treated as qualified principal residence indebtedness is $2 million ($1 million if married filing separately). Qualified principal residence indebtedness cannot be excluded from income if the cancellation was for services performed for the lender or on account of any other factor not directly related to a decline in the value of the home or to the taxpayer's financial condition.

3. This provision only applies to mortgage debt discharged prior to January 1, 2013.

SECTION 108 FLOW CHART
Income from Discharge of Indebtedness ("COD")



*Exclusion for residential property applies only to a primary residence and to debt that was related to the acquisition, refinance of acquisition debt or associated with improvements made directly to the primary residence.

Additionally, debt modification on a residence may be deemed cancellation of debt – potential liability if debt secured by primary residence is not eligible for exclusion under § 108(a)(1)(E)

**Temporary and proposed Treasury Regulations issued in August 2010 require acceleration of deferred COD income when:

1. A corporation changes its tax status;
2. A corporation ceases its corporate existence in a transaction to which § 381(a) does not apply; or
3. A corporation engages in a transaction that impairs its ability to pay the tax liability associated with the deferred COD income

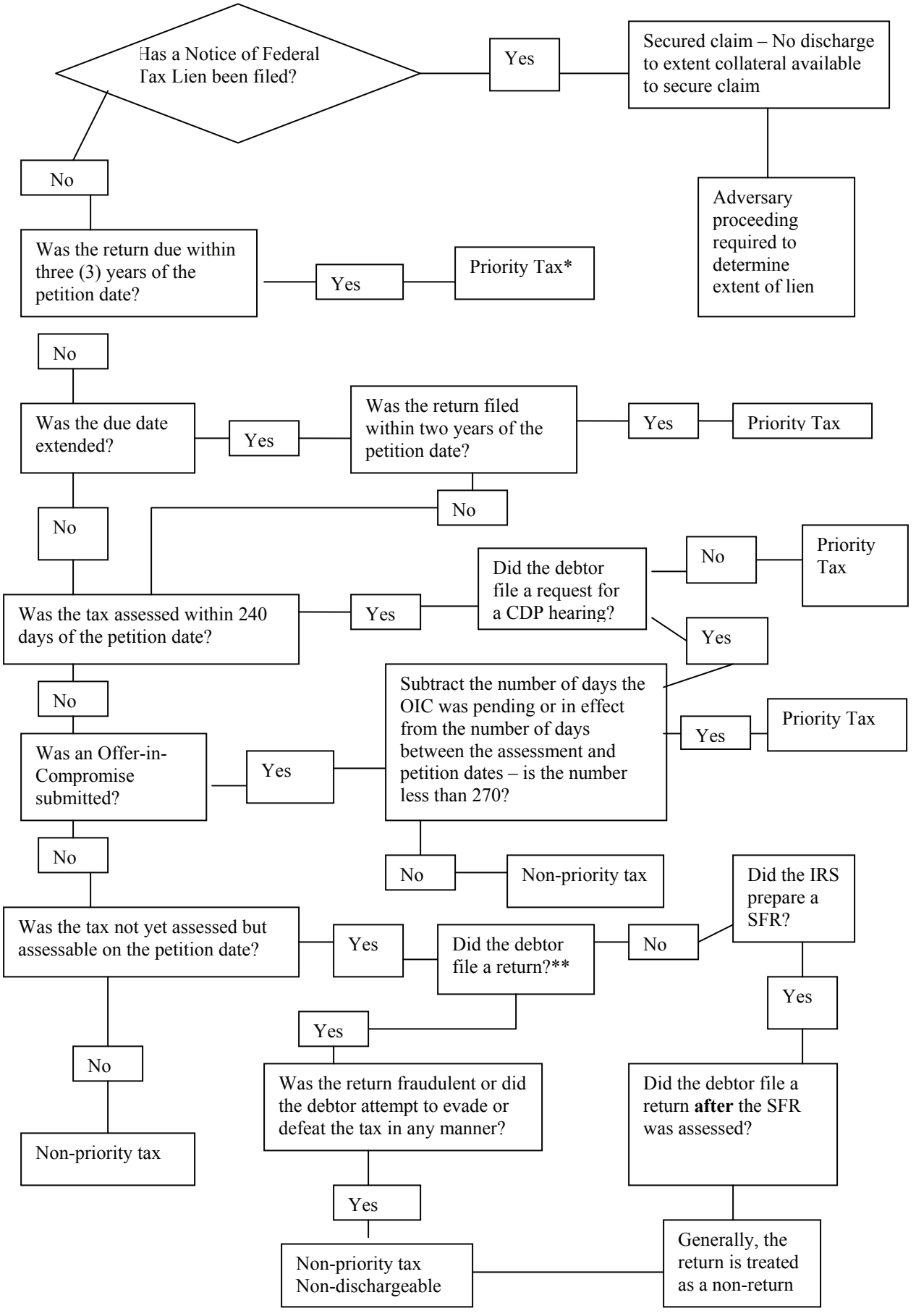
Under § 108(i) COD income is deferred ratably over a 5 year period and is included in ordinary income.

If election is taken:

1. It is made by the entity
2. No basis or attribute reduction
3. Taxpayer actions may trigger acceleration

*** Transfers to a Subchapter S corporation from an LLC: under § 357(a) liability in excess of basis are subject to tax and are not eligible for the exclusion under § 108

DISCHARGE OF INCOME TAX FLOW CHART



*Penalties on a priority tax are dischargeable, interest is not

**The term "Return" has been expanded under Section 523 and includes "a written stipulation to a judgment or a final order entered by a non-bankruptcy tribunal." Therefore, a Tax Court Decision, whether consensual or not, will be a return under Section 523(a)(1)(B).