Consumer Track

The Internal Revenue Code and the Bankruptcy Code

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Bankruptcy, Taxes, and Alternative Universes

In the palpable space/time continuum: (a) Most issues that relate to the priority of taxes are straightforward and are addressed by 11 U.S.C. §507(a)(8); (b) Most issues that relate to the exception of taxes from discharge are straightforward and are addressed by 11 U.S.C. §523(a)(1) and 11 U.S.C. §523(a)(7) [tax penalties]; (c) Most issues that relate to the allowed secured status of tax claims are addressed by the provisions of the Bankruptcy Code that apply to secured claims generally, keeping in mind that tax liens are statutory liens [11 U.S.C. §101(53)], and thus for example are not subject to certain provisions like 11 U.S.C. §522(f), and that 11 U.S.C. §724 provides special rules in Chapter 7 cases for subordination of claims secured by tax liens to certain other types of claims; and (d) Most issues of pure tax are determined by the rules provided by the Internal Revenue Code [Title 26 of the United States Code] and state tax codes.

Quantum mechanics theoretically posits the existence of alternative universes. In the interstices between palpable bankruptcy and non-bankruptcy universes lies a metaphysical realm in which theories about the nature of taxes in relation to the Bankruptcy Code collide. The resulting cosmic consequences may be illustrated by the following conundrums:

1. When is a tax return not a tax return? **[Compare: (a) *In re McCoy*, 666 F.3d 924 (5th Cir. 2012; (b) *Perkins v. Massachusetts Department of Revenue*, 2014 WL 896745 (D. Mass. 2014); (c) *Gonzalez v. Massachusetts Department of Revenue*, 2014 WL 888460 (1st Cir. BAP (Mass.) 2014)/ NOTE, 11 U.S.C. §1308(c)]**.

2. When is tenancy by the entireties property not tenancy by the entireties property? **[*United States v. Craft*, 122 S.Ct. 1414 (2002)]**.

3. When is first in time not first in right? **[26 U.S.C. §6321; 26 U.S.C. §6323, especially subsections (a) and (b)/ priority of recorded state tax liens vis-a-vis federal tax liens]**.

4. When is a spendthrift, anti-alienation provision in a retirement plan not a spendthrift, anti-alienation provision, and when is a tax claim secured by a retirement plan containing a spendthrift, anti-alienation provision not an allowed secured claim? **[Start with: 11**

U.S.C.§541(b)(7) and *Patterson v. Shumate*, 112 S.Ct. 2242 (1992)/ <u>then compare:</u> (a) *In re Lyons*, 148 B.R. 88 (Bankr. Dist. of Columbia 1992), and *In re Snyder*, 343 F.3d 1171 (9th Cir. 2003)].

5. When is an apparent tie in tax lien priorities not a tie? **[*United States v. McDermott*, 113 S.Ct. 1526 (1993)].**

6. When is TIP other than a commonly unreported source of taxable income? **<u>See</u>, *United States of America v. Specialty Cartage*, 115 B.R. 164 (Bankr. N.D. Ind. 1989), <u>aff'd</u> 113 B.R. 484 (N.D. Ind. 1990)].**

7. When are statutory tax liens, judicial liens and security interests identical, yet at the same time totally different, under 11 U.S.C. §506(b)? **[*United States v. Ron Pair Enterprises, Inc.,* 109 S.Ct. 1026 (1989)]**.

The universe is a vast, cold, dark place in which certain tax rules of the Internal Revenue Code and of state tax codes are drawn into, and at times subsumed by, the gravitational pull of the Bankruptcy Code. May you avoid the resulting black hole.

THE INTERNAL REVENUE CODE AND THE BANKRUPTCY CODE—Survival of Tax Attributes and Special S Corporation Issues

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THE INTERNAL REVENUE CODE AND THE BANKRUPTCY CODE

Survival of Tax Attributes and Special S Corporation Issues

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I. APPLICATION OF SECTION 382/383 LIMITATIONS

A. Basic Section 382 Provisions

A corporation that has a section 382[1] ownership change is subject to an annual limitation[2] on its ability to use net operating loss ("NOL") carryovers and certain other tax attributes allocated to or arising before the ownership change ("pre-change NOLs") to offset taxable income arising after the ownership change date. Assuming that a corporation does not have a net unrealized built-in loss ("NUBIL")[3] on a change date, section 382 should not restrict the offset of NOLs allocated to or arising after the ownership change ("post-change NOLs") against future income. The section 382 limitation applies on an annual basis to taxable years ending after the date of the ownership change.

A section 382 ownership change occurs when, generally, over a three-year testing period, the stock ownership percentages (by value) of "5-percent shareholders" have increased, in the aggregate, by more than 50 percentage points over such shareholders' lowest ownership percentages within the testing period (generally, a three-year period).

A 5-percent shareholder is a person who directly or indirectly owns five percent or more of the total value of the outstanding stock of the loss corporation. The term 5-percent shareholder also refers to a group of shareholders that individually own less than five percent of the total value of the outstanding stock of the loss corporation (a "public group"). If a 5-percent owner is an individual or certain other specified persons, it constitutes a 5-percent shareholder. If a 5-percent owner is an entity, *e.g.*, a corporation, partnership, or trust, the loss corporation is required to look through the entity (and through any higher-tier entity) in order to determine whether owners of the entity are indirectly 5-percent shareholders of the loss corporation. It is the ownership of these ultimate 5-percent shareholders that is considered when determining whether a greater-than-50-percentage-point increase has occurred.

B. Ownership Change

In general, an "ownership change" occurs under section 382 when, on a particular testing date, the percentage stock ownership (by value) of one or more 5-percent shareholders has increased

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[1] Except as otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and to the regulations thereunder.

[2] In the case of an affiliated group of corporations filing a consolidated return, this limitation is computed, in general, by reference to the stock value of the United States consolidated group immediately before the ownership change, subject to certain adjustments.

[3] A NUBIL is generally defined as the excess of a loss corporation's aggregate assets' basis over their aggregate fair market value, subject to a de minimis threshold. Section 382(h)(3). Certain adjustments are also made for items of built-in income or deduction. Section 382(h)(6)(C).

by more than 50 percentage points over the lowest percentage stock ownership (by value) held by such shareholders at any time during this testing period.[4]

C. Loss Corporation

Section 382 applies only to loss corporations. A loss corporation is defined in section 382 as a corporation entitled to use an NOL carryover or having an NOL for the taxable year in which the ownership change occurs. In addition, a loss corporation includes any corporation with a NUBIL. Section 383 effectively applies the rules of section 382 to limit the use of certain capital losses and excess credits. Consequently, the term "loss corporation" includes a corporation that is entitled to use a capital loss carryover or a capital loss arising in the taxable year of the ownership change, a foreign tax credit, a general business tax credit, and/or a minimum tax credit.

Treas. Reg. §§ 1.1502-90 through -99 provide the rules for the application of the section 382 principles to an affiliated group of corporations filing a consolidated return. Therein, the regulations generally treat a consolidated group as a single entity. As such, the general rules provide that the determination of whether the members of a consolidated group have experienced an ownership change is made by reference to whether the common parent of the consolidated group experienced an ownership change (the "parent change method"). For subsidiaries that leave or join the consolidated group, section 382 is applied on a separate-company basis. A subsidiary that experiences an ownership change within six months before or after, or at the same time as, the subsidiary joins the consolidated group (or that do not experience an ownership change within five years after joining the consolidated group) effectively are folded into the consolidated group thereafter.

D. Testing Date and Testing Period

A testing date generally occurs whenever there is a change in the ownership of shares by a 5-percent shareholder and such change causes a change in the percentage of stock ownership (by value) of any 5-percent shareholder.[5] In addition, a testing date occurs upon certain "equity structure shifts."[6] Thus, generally an issuance of stock to existing shareholders or to new investors would trigger a testing date, as would a non-pro rata redemption of stock or the transfer by an existing 5-percent shareholder of some or all of its stock to a third party or an existing shareholder. Also, where a loss corporation has a 5-percent owner, which is itself a corporation, partnership, or other entity, a shift in the ownership among the owners of such entities could also trigger a testing date.

In general, the testing period is the three-year period preceding a given testing date. Thus, each 5-percent shareholder's percentage on the testing date must be compared against his/her minimum percentage at any time during the prior three years. The testing period may be less than three years based on the facts. In particular, if (i) the loss corporation has been in existence for less than three years (and a loss corporation during its entire existence), (ii) the corporation

[4] Section 382(g).
[5] Treas. Reg. § 1.382-2(a)(4).
[6] The term "equity structure shift" includes most tax-free reorganizations. Temp. Reg. § 1.382-2T(c)(2).

was not a loss corporation for the entire three-year period, or (iii) an ownership change occurred less than three years before the testing date, then the testing period will begin on the loss corporation's date of inception, the first day of the taxable year during which the corporation became a loss corporation, or the day after the date of the last ownership change, respectively, and ending on the testing date until the given testing date is more than three years after the date of inception or date of the last ownership change.[7]

While private companies may know the identities of its shareholders, the stock of most public companies is held in "street name." Thus, a public may not have in its records any information regarding the identity of its shareholders. However, the Securities Exchange Act of 1934 requires certain reports to be filed periodically with the Securities and Exchange Commission ("SEC") by those persons who are the beneficial owners of more than five percent of the outstanding shares of a class of stock issued by a public company. These reports are filed on Schedules 13D and 13G. Loss corporations are permitted to rely on the existence and absence of these filings to determine their 5-percent shareholders.[8] In other words, even if a loss corporation believes that a person may be a 5-percent shareholder, if there is no Schedule 13D or 13G filed with the SEC, that person is not required to be treated as a 5-percent shareholder.

There are important differences between the criteria for 5-percent shareholder status and the requirement to file an SEC report of beneficial ownership. First, under SEC rules, beneficial ownership of stock consists of the right to vote the stock or to determine whether to dispose of it. In contrast, for federal income tax purposes, ownership generally requires the right to retain the dividends and the proceeds of sale of the stock. Second, for this reason, certain SEC filers may not be 5-percent shareholders because they do not possess the requisite *economic* rights. This is frequently the case with SEC filers who disclose that they are investment advisers, fiduciaries, or controlling persons of certain entities. Third, while the five-percent threshold for SEC purposes is determined on a class-by-class basis, stock ownership for section 382 purposes is determined on the basis of the value of the shares owned compared with the total value of the loss corporation's outstanding stock. Fourth, somewhat curiously, the quantitative threshold for an SEC filer is *more than* five percent, while the threshold for section 382 purposes is *at least* five percent.

E. Stock Interests

For section 382 purposes, ownership percentages are based on the value of equity characterized as stock (including stock that would be issued upon the deemed exercise of an option or similar interest). Common stock and voting or convertible preferred stock generally constitute section 382 stock interests. Contingent stock interests, such as options or warrants, may be included in determining the ownership percentages pursuant to specific rules, summarized below, based on the value of the stock into which such contingent interests could convert.

The treatment of nonvoting preferred stock for section 382 purposes depends on its other terms and possibly its issuance date. If stock meets the definitional requirements of section 1504(a)(4),

[7] Temp. Reg. § 1.382-2T(d).
[8] Treas. Reg. § 1.382-2T(k)(1).

it is excluded from determining ownership percentages (and is sometimes referred to as "pure" or "plain vanilla" preferred stock).

Section 1504(a)(4) provides that stock is considered pure preferred stock when it:

- is not entitled to vote,
- is limited and preferred as to dividends and does not participate in corporate growth to any significant extent,
- has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and
- is not convertible into another class of stock.

In addition, if stock would meet these criteria but for the existence of voting rights in the event of dividend arrearages, the regulations treat such stock as "not stock" for this purpose.[9]

Notwithstanding the foregoing, the regulations provide the Service with the authority to treat interests not otherwise constituting stock as stock for section 382 testing purposes. Pursuant to Temp. Reg. § 1.382-2T(f)(18)(iii), an ownership interest that would otherwise not be treated as stock for section 382 purposes, *i.e.*, pure preferred stock, would nevertheless be treated as stock for section 382 purposes if it meets *all* of the following requirements:

(A) as of the time of its issuance or transfer to (or by) a 5-percent shareholder (or a person who would be a 5-percent shareholder if the interest not constituting stock were treated as stock), such interest offers a potential significant participation in the growth of the corporation,

(B) treating the interest as constituting stock would result in an ownership change, and

(C) the amount of the pre-change losses (determined as if the testing date were the change date and treating the amount of any net unrealized built-in loss as a pre-change loss) is more than twice the amount determined by multiplying (1) the value of the loss corporation (as determined under section 382(e)) on the testing date, by (2) the long-term tax exempt rate (as defined in section 382(f)) for the calendar month in which the testing date occurs.

F. Options and Warrants

1. Generally

Generally, any contingent purchase, warrant, convertible debt, put, or stock option subject to a risk of forfeiture, contract to acquire stock, or similar interest is treated as an option for purposes of section 382.[10] For testing dates after November 4, 1992, an option or similar interest may only be treated as exercised if it meets one of three detailed qualitative tests: the income test, the ownership test, or the control test. The first component of all three tests is whether a principal purpose of the issuance, transfer, or structuring of the option is to avoid or ameliorate the impact

[9] Treas. Reg. § 1.382-2(a)(3)(i).
[10] Treas. Reg. § 1.382-4(d)(9).

of an ownership change of the loss corporation.[11] Factors to consider in making this determination include:

(a) the business purpose for the issuance, transfer, or structuring of the option;
(b) the likelihood that the option will be exercised (taking into account contingencies), and
(c) the consequences of treating the option as exercised.[12]

2. Options/Warrants Issued "In the Money"

General principles of tax law apply to determine whether an instrument is an option or stock for purposes of section 382.[13] From a theoretical perspective, some options or warrants could be treated as stock if, at the time the instrument is granted, the option or warrant is sufficiently "in the money" that it is essentially equivalent to a stock interest. The Service has issued guidance to address certain analogous constructive stock ownership rules under section 551 relating to foreign personal holding company income taxed to United States shareholders.[14] Revenue Ruling 82-150 provided that certain holders of an option that could be exercised at any time were treated as owning the shares of the underlying stock because the exercise price of their options was only 30 percent of the fair market value of the underlying shares of stock as measured on the date of the option's issuance.[15]

Accordingly, notwithstanding the principles of Treas. Reg. § 1.382-4(d), which determine whether an option should be treated as having been exercised for section 382 purposes, certain instruments identified as "options" may instead be treated as stock under general federal tax principles. In these circumstances, the section 382 regulations are not applied, and the instrument is treated as stock for all federal tax purposes (including section 382).

3. Restricted Stock

Many corporations issue restricted stock to various individuals that vest over a period of time. Such stock is usually issued as a compensatory device, in order to provide an incentive to remain employed by the company or its subsidiaries, and to enhance the value of the stock. There is a question as to whether these shares should be treated as issued on the grant date, or treated as an option until the shares vested. Treas. Reg. § 1.382-4(d)(9)(i) defines an option in part as any contingent purchase, warrant, convertible debt, put, or stock subject to a risk of forfeiture. Because the restricted stock is subject to a risk of forfeiture, it should meet the definition of an option for this purpose. However, in the only guidance on this issue, the Service has issued a private letter ruling that restricted stock should be treated as outstanding stock for purposes of section 382.[16]

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[11] A principal purpose can exist even when it is outweighed by non-tax reasons.
[12] Treas. Reg. § 1.382-4(d)(6).
[13] Treas. Reg. § 1.382-4(d)(9)(iv).
[14] Rev. Rul. 82-150, 1982-2 C.B. 110.
[15] See also Rev. Rul. 85-87, 1985-1 C.B. 268 (an "in-the-money" put option was in substance a contract to sell underlying stock where the facts and circumstances indicated the exercise of the option was almost certain).
[16] PLR 9422048 (Mar. 8, 1994). This ruling was issued prior to the issuance of current Treas. Reg. § 1.382-4(d)(9); however, Treas. Reg. § 1.382-2T(h)(4)(v)(A) contained a similar rule, and thus, the Service's conclusion in this

G. Shareholders

1. Generally

For purposes of section 382, 5-percent shareholders include those direct and indirect shareholders who own five percent or more of the outstanding stock of the loss corporation. "Indirect" ownership by 5-percent individual shareholders is established by complex attribution rules which apply a percentage look-through approach to corporations, partnerships, or other entities which directly (or indirectly) hold five percent or more of the loss corporation. These entities are referred to as first-tier or higher-tier entities. Another form of attribution occurs among certain lineal family members that are treated as a single individual 5-percent shareholder.

All holders of a less-than-five-percent interest that are not otherwise attributed to a 5-percent shareholder are aggregated into one or more "public groups" of shareholders, and each of these groups is treated as a separate (public) 5-percent shareholder. Note that the term "public" in respect of such groups is a defined term under applicable regulations and applies whether or not the shares held by any such groups are, in fact, publicly traded.

A 5-percent shareholder's percentage stock ownership on each testing date is the fair market value of the section 382 stock owned by such 5-percent shareholder as a percentage of the value of all the outstanding section 382 stock of the corporation at the close of the testing date. Pursuant to Treas. Reg. § 1.382-2(a)(3)(i), each share of stock with identical terms is assumed to have the same value for purposes of the owner shift calculation.

For section 382 purposes, the ownership of first-tier and higher-tier entities is tracked and treated similarly to that of the loss corporation.

2. Treatment of Chapter 11 Reorganization Plan

Although the Code provides special rules for determining the *consequences* of an ownership change that occurs pursuant to the consummation of a plan of reorganization under the Bankruptcy Code, the Code does not generally provide any guidance on the determination of *whether* an ownership change has occurred under these circumstances. In many bankruptcy cases, the existence of an ownership change is clear because the interests of the historic shareholders of the loss corporation are either eliminated altogether or significantly reduced in favor of the historic creditors.

If an ownership change occurs in a title 11 case,[17] a loss corporation is subject to one of two provisions setting forth the consequences of the ownership change. Both are unique to title 11 or

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ruling could still be relevant. Although not clear from the facts in the ruling, it appears that the Service did not consider the making of a section 83(b) election relevant to its conclusion. See also PLR 9712029 (Dec. 23, 1996) and PLR 9804033 (Oct. 24, 1997) for a discussion of restricted stock in a consolidated return context.

[17] Section 382(*l*)(5) provides that the term "title 11 or similar case" has the meaning given to the term by section 368(a)(3)(A). Under this latter provision, the term means a case under the federal Bankruptcy Code or a receivership, foreclosure, or similar proceeding in a federal or state court.

similar cases, and recognize the principles established by the Bankruptcy Code. Briefly, section 382(*l*)(5) makes inapplicable the section 382 limitation, but requires the loss corporation to reduce its NOLs for certain interest deductions that have been previously claimed. Section 382(*l*)(6) applies a section 382 limitation, but permits the corporation—effectively—to consider the equity value of the corporation immediately after emergence, rather than immediately before the ownership change. At the same time, section 382(*l*)(6) does not require any downward adjustments to the NOL for interest expense.

Section 382(*l*)(5) is based on the premise that, at some point in the process of deterioration of the financial condition of the corporation, the long-term creditors had begun to assume the risks and rewards of the holders of the equity of the corporation. Thus, if the shareholders and the pre-emergence creditors own 50 percent or more of the loss corporation after the ownership change, no section 382 limitation will apply.[18] However, consistent with the treatment of such creditors as holders of equity, the corporation is required to reduce its NOLs by the amount of interest expense previously deducted during a specified period on indebtedness that was actually converted into stock in the bankruptcy case. The specified period consists of three full taxable years preceding the ownership change plus the portion of the taxable year of the change that precedes that change.[19]

Under the regulations, qualified creditors holding qualified indebtedness are those creditors who held their claims for a period of at least 18 months preceding the commencement of the case, as well as those whose claims arose in the ordinary course of the corporation's trade or business and held at all times by the same owner.[20] Among other considerations, these rules limit the extent to which claims can be transferred in the 18-month period preceding commencement of the case, and also limit the ability of a corporation to raise substantial amounts capital through the purported issuance of debt that will ultimately be converted into equity.

A loss corporation that uses section 382(*l*)(5) also undertakes a significant risk regarding the future use of its NOLs. If it has another ownership change within two years after emerging from bankruptcy, the section 382 limitation with respect to that second ownership change will be zero.[21] Accordingly, despite the benefits that section 382(*l*)(5) can provide, a corporation may choose not to use this provision if there is a risk of a second ownership change within this period.

A loss corporation may elect not to use section 382(*l*)(5) even if it otherwise qualifies.[22] In addition, a loss corporation may not qualify to use section 382(*l*)(5) because, for example, of excessive trading in claims before the commencement of the case, or because shareholders and qualifying creditors do not hold at least 50 percent of the loss corporation's stock upon emergence. In either case, the loss corporation will default to section 382(*l*)(6).

Section 382(*l*)(6) embodies the "fresh start" principles of the Bankruptcy Code. Recognizing that a loss corporation must generally determine its annual section 382 limitation by taking into

[18] Section 382(*l*)(5)(A).
[19] Section 382(*l*)(5)(B).
[20] Treas. Reg. § 1.382-9(d)(2).
[21] Section 382(*l*)(5)(D).
[22] Section 382(*l*)(5)(H).

account the value of its stock immediately before the ownership change, the application of these general rules would often result in a loss corporation in bankruptcy having a section 382 limitation of zero (or near zero). The statute provides that a loss corporation may determine the value of its stock by taking into account the "increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction." Due to the complexities of making this determination, the regulations merely permit the corporation to take into account all of the value of the stock, as determined immediately after the ownership change.[23] In order to prevent excessive "stuffing" of the loss corporation for the purpose of increasing the section 382 limitation, the regulations provide that the value of the stock, as so determined, may not exceed the value of the gross assets of the corporation determined immediately before the ownership change.[24]

In cases where a loss corporation has a choice between using section 382(*l*)(5) and section 382(*l*)(6), it should carefully examine the amount of NOLs that it would retain after making the required reductions under section 382(*l*)(5). In other words, if there is an insignificant NOL that remains under this provision, it may not make sense to be freed of a section 382 limitation. In contrast, if the remaining NOL is a material number, or if the loss corporation may have a NUBIL and thus be subject to limitations under section 382(h), the application of section 382(*l*)(5) may provide a significant benefit. On the other hand, if the corporation is at risk for a second ownership change within two years after the first ownership change, the application of section 382(*l*)(6) may be beneficial.

3. Coordinated Acquisition of Stock

Section 382 generally focuses on persons that acquire five percent or more of the shares of a loss corporation.[25] Treas. Reg. § 1.382-3(a)(1) provides that an entity is any corporation, estate, trust, association, company, partnership, or similar organization. An entity also includes a group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition of stock. However, an investment advisor that holds shares on behalf of others generally is not considered an entity for this purpose.

4. Ownership Presumptions

Once a shareholder's interest falls below five percent within a testing period, the loss corporation has certain alternatives for treating the shareholder's ownership during the remainder of the testing period. First, although not required, the loss corporation may rely on "actual knowledge" of the shares owned by the ultimate shareholder that falls below five percent during the testing period and continue to track these shares separately.[26] Second, the loss corporation can rely on the ownership presumptions of Treas. Reg. § 1.382-2T(j)(1)(v) and/or Treas. Reg. § 1.382-2T(g)(5)(i)(B) and can assume that the interest of the shareholder remains constant (except for

[23] Treas. Reg. § 1.382-9(j)(1).
[24] Treas. Reg. § 1.382-9(j)(2).
[25] Treas. Reg. § 1.382-2T(g)(1)(iv).
[26] *See*, *e.g.*, PLRs 200024047, 9234034, and 9104043 permitting taxpayers to use such actual knowledge.

transactions described in Treas. Reg. § 1.382-2T(j)(2)(vi)) for the remainder of the testing period once the shareholder's interest drops below five percent.[27]

The loss corporation also has certain alternatives for tracking the ownership of a shareholder that becomes a 5-percent shareholder during the testing period before that shareholder becomes a 5-percent shareholder. First, although not required, the loss corporation may rely on "actual knowledge" of the shares owned by the ultimate shareholder that becomes a 5-percent shareholder during the testing period and may track these shares separately at all times during the testing period.[28] Second, the loss corporation can rely on the ownership presumption of Treas. Reg. § 1.382-2T-(j)(1)(v) and/or Treas. Reg. § 1.382-2T(g)(5)(i)(A) (the "zero low presumption") and can assume that any interest owned by the shareholder prior to the acquisition that caused the shareholder to become a 5-percent shareholder was owned by a public group and not the shareholder in question.

5. Treatment of Public Ownership

(a) In General

The section 382 rules generally treat certain transactions, *e.g.*, issuance of stock by the loss corporation to the public and sales of loss corporation stock by 5-percent shareholders to the public, as if a new public group separate from any pre-existing public groups acquired the stock.[29] In effect, the section 382 rules presume that persons representing a completely new set of investors purchase such shares. Thus, this set of investors will generally constitute a public group and is treated as a 5-percent shareholder separate from other 5-percent shareholders or previously identified public groups treated as 5-percent shareholders.[30] The presumption that this group is separate from all other shareholders (the "full segregation presumption") maximizes the extent to which the issuance of stock will cause an owner shift and contribute toward an ownership change.

A loss corporation may rebut the full segregation presumption and, in certain cases, potentially may improve its section 382 position, if it has actual knowledge of an overlap in the constituents of the new group acquiring shares and the pre-existing shareholder groups.[31]

For testing dates occurring taxable years beginning after November 4, 1992, the regulations provide two key exceptions to the full segregation presumption. That is, special rules alleviate some of the impact that the full segregation presumption can have on a corporation. The two exceptions to the full segregation presumption are known as the "small issuance" exception and the "cash issuance" exception.

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[27] *See also*, PLRs 200326003 and 9147031.
[28] *See*, *e.g.*, PLRs 200024047, 9234034, and 9104043 permitting taxpayers to use such actual knowledge.
[29] Redemptions from the public are also subject to the segregation rules, in that the non-redeemed shareholders are treated as increasing their proportionate interest in the loss corporation.
[30] Treas. Reg. § 1.382-2T(j)(2)(iii)(B)-(C).
[31] Treas. Reg. § 1.382-2T(j)(2)(iii)(A).

(b) Small Issuance Exception

The small issuance exception treats a new issuance of shares as if the shares are acquired entirely by the pre-existing public groups.[32] In general, this exception applies to an issuance in a given year consisting of less than ten percent of the number of shares of a class or of the equity value of the corporation outstanding at the beginning of the taxable year. However, the loss corporation may not apply the small issuance exception on a class-by-class basis if, during the taxable year, more than one class of stock is issued in a single issuance (or two or more issuances that are treated as a single issuance).[33] Furthermore, the small issuance exception does not apply to any portion of a single issuance that exceeds the ten-percent limit, nor to any portion of a series of separate issuances which are pursuant to a single plan or arrangement that occur at approximately the same time where the shares issued under that plan or arrangement exceed the ten-percent limit.[34] In chronological order, each issuance, whether to the public or to 5-percent shareholders (or first/higher-tier entities) that qualifies as a small issuance based on its size, reduces the number of shares (or dollar value of shares) to which the small issuance can be applied. Note that the small issuance exception generally does not apply to "equity structure shifts."[35] An equity structure shift includes most tax-free reorganizations.[36]

The shares eligible for the small issuance exception are treated as issued to the pre-existing groups pro rata based on the relative value held by each public group. Thus, the owner-shift impact of an issuance is reduced to the extent that the shares are treated as being issued to a public group that does not contribute to an owner shift on the testing date.

(c) Cash Issuance Exception

The cash issuance exception allows a portion of stock issued for cash to the public to be treated as acquired by pre-existing public groups and the remaining stock as acquired by a new segregated public group.[37] This exception generally is of material benefit only if a significant portion of the corporation's stock before the issuance is held by pre-existing public groups (rather than non-public 5-percent shareholders) that have declining ownership percentages during the testing period. The treatment of one or more issuances as a single issuance does not apply in determining whether stock is issued solely for cash.[38] In addition, the total amount of stock qualifying for this exception cannot exceed the total amount of stock issued in the issuance less the amount of that stock that is owned by a 5-percent shareholder (other than a direct public group) immediately after the issuance.[39] If both the cash issuance exception and the small issuance exception potentially apply to an issuance, the small issuance exception "trumps," and the cash issuance exception only applies to the portion of the issuance (if any) not exempted under the small issuance exception.[40]

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[32] Treas. Reg. § 1.382-3(j)(2).
[33] Treas. Reg. § 1.382-3(j)(2)(iii)(D).
[34] Treas. Reg. § 1.382-3(j)(8).
[35] Treas. Reg. § 1.382-3(j)(6).
[36] Treas. Reg. § 1.382-2T(e)(2).
[37] Treas. Reg. § 1.382-3(j)(3).
[38] Treas. Reg. § 1.382-3(j)(3)(ii)(B).
[39] Treas. Reg. § 1.382-3(j)(4).
[40] Treas. Reg. § 1.382-3(j)(3)(iii).

(d) Recently-Adopted Exceptions to Segregation Rules

In order to reduce the scope of the segregation rules, in October 2013 the Service and Treasury issued final regulations adopting additional exceptions. Under these rules, stock transferred by certain 5-percent shareholders to one or more public groups is not required to be segregated into a new public group.[41] Using thresholds similar to the small issuance exception, the regulations provide that the segregation rules will not apply to a "small redemption."[42] Finally, the segregations rules will not apply to transactions involving the stock of certain first-tier and higher-tier entities.[43]

(e) Proportionate Acquisition of Exempted Stock

In general, each direct public group that exists immediately before a small or cash issuance is treated as acquiring its proportionate share of the amount of stock exempted from the application of the full segregation presumption in such issuance.[44] However, if the loss corporation actually knows that the aggregate amount acquired by pre-existing direct public groups in the small or cash issuance exceeds amount determined under Treas. Reg. § 1.382-2T(j)(5)(i), then the loss corporation may treat pre-existing direct public groups as acquiring in the aggregate more stock than the amount so determined.[45]

6. Reliance on SEC Filings and Treatment of Investment Advisors

As indicated above, loss corporations whose stock is publicly traded are permitted to rely on the existence or absence of SEC Schedules 13D or 13G (or any similar schedules) to identify 5-percent shareholders.[46] Generally, only the "economic owners" of the shares of a loss corporation should be considered in determining its 5-percent shareholders. The activity of any entities that do not have economic ownership of their shares in a loss corporation, but rather hold those shares on behalf of others, who do have such economic ownership, should not contribute to an owner shift.

The Service has held that a person who has the right to dividends and proceeds from the sale of stock ("economic ownership") is the owner of the stock for purposes of section 382. Thus, if a filer of a Schedule 13D or 13G holds shares of common stock on behalf of others but does not have economic ownership of such stock, such filer is not considered a shareholder for section 382 purposes. Rather, the economic owners on whose behalf the filer holds and reports the shares are considered to be the shareholders for section 382 purposes. In addition, the relevant guidance held that the reporting of shares by an investment advisor did not constitute a formal or informal understanding among any of the affected entities to make a coordinated acquisition of stock simply because an investment advisor has authority to undertake a series of specified activities with respect to the stock.

[41] Treas. Reg. § 1.382-3(j)(13).
[42] Treas. Reg. § 1.382-3(j)(14).
[43] Treas. Reg. § 1.382-3(j)(15).
[44] Treas. Reg. § 1.382-3(j)(5)(i).
[45] Treas. Reg. § 1.382-3(j)(5)(ii).
[46] Treas. Reg. § 1.382-2T(k)(1)(i). *See also*, PLRs 9104043 and 9533024.

H. Treatment of Fluctuations in Value

Section 382(*l*)(3)(C) provides that, in determining the ownership of a loss corporation's stock, any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account. The Service has not issued any regulations[47] or other published guidance to determine how to apply these rules, but has issued a few private letter rulings. Therefore, dealing with increases in ownership due to fluctuations in value has been the subject of some uncertainty. During 2004 and 2005, the Service issued private letter rulings that indicated that a loss corporation could disregard an increase in ownership attributable to fluctuations in value of its common stock relative to its convertible preferred stock.[48] Unfortunately, the rulings provided no specific guidance for calculating an ownership increase attributable (or not attributable) to fluctuations in value.

In Notice 2010-50,[49] the Service provided interim guidance pending the issuance of more formal guidance. The Service permitted loss corporations a choice between using a "full value methodology," which does not adjust for fluctuations in value, and a "hold constant principle," which seeks to back out the effects of fluctuations in value over time. Under this latter principle, taxpayers are also provided with alternative methods of applying this rule.

I. Section 382 Limitation

1. Generally

The section 382 limitation is generally an amount equal to (i) the fair market value of all of the corporation's outstanding equity, both common stock and preferred stock (including section 1504(a)(4) preferred stock), immediately prior to the ownership change[50] (potentially subject to various adjustments, discussed in the succeeding paragraphs) multiplied by (ii) the applicable long-term tax-exempt rate.[51] In valuing the equity of the loss corporation for purposes of computing the section 382 annual limitation, control premiums and discounts for restricted transferability may be included. In addition, some value may be reasonably included for in-the-money options and similar interests.[52]

2. Required Reductions in Equity Value

Ascertaining the value of a loss corporation's stock immediately before an ownership change (modified, as appropriate, by section 382(*l*)(6)) is merely the first step in the process of determining the amount of the section 382 limitation for an ownership change. The Code identifies several adjustments—all of them reductions—that may be required in appropriate circumstances.

[47] Temp. Reg. § 1.382-2T(*l*) has been reserved for this purpose for more than 20 years.
[48] *See*, *e.g.* PLRs 200411012 and 200511008.
[49] 2010-27 I.R.B. 12.
[50] Section 382(e)(1).
[51] Section 382(b)(1).
[52] PLR 9332004 and PLR 200442011.

(a) Anti-Stuffing Rules

The section 382 anti-stuffing rules seek to reduce the value of the loss corporation by the amount of any capital contributions made as part of a plan, a principal purpose of which is to avoid or increase a section 382 limitation.[53] In this regard, the statute treats any capital contributions made within the two-year period prior to the ownership change as being part of a plan to avoid or increase a section 382 limitation.[54] This two-year presumption is quite broad, and inevitably ensnares transactions not having an avoidance purpose.

Perhaps mindful of this broad application, the report of the Conference Committee on section 382 directs the Treasury Department to write regulatory exceptions to the two-year rule.[55] The exceptions include the following: (1) capital contributions made upon formation of the corporation (other than assets with a net built-in loss); (2) contributions made before the first loss year; and (3) contributions made to meet operating expenses. The Treasury has not yet issued any regulations in this area. In several private letter rulings that have been issued, the Internal Revenue Service has applied a very literal interpretation of the two-year presumption rule, making exceptions only in the case of capital contributions used to fund current operations.[56]

In Notice 2008-78, 2008-41 I.R.B. 851, the Service and Treasury announced their intention to propose regulations under these anti-stuffing rules, and invited comments on the regulations in advance of their publication. Pending the issuance of such regulations, the Notice also provided guidance on which taxpayers can rely for certain ownership changes occurring before the effective date of the regulations. Specifically, the Notice provides that taxpayers may rely on the provisions of Section III of the Notice with respect to an ownership change that occurs in any taxable year ending on or after September 26, 2008.

The Notice effectively removes the two-year presumption, by providing that a capital contribution will not be presumed to be part of a plan a principal purpose of which is to avoid or increase a section 382 limitation solely as a result of having been made during the two-year period ending on the change date. Instead, the determination of whether a capital contribution will be subject to the anti-stuffing rules will be made based on all of the facts and circumstances. The Notice further provides four safe harbors expected to be included in the proposed regulations, which incorporate some of the principles of the section 355(e) regulations (relating to a requirement to recognize corporate-level gain in an otherwise qualifying section 355 distribution). Under these safe harbors, a capital contribution will not be considered part of a plan if—

1. The contribution is made by a person who is neither a controlling shareholder (determined immediately before the contribution) nor a related party, no more than 20 percent of the total value of the loss corporation's outstanding stock is issued in

[53] Section 382(*l*)(1)(A).
[54] Section 382(*l*)(1)(B).
[55] The Conference Committee is comprised of members of the two tax-writing committees in Congress, the House Ways and Means Committee and the Senate Finance Committee. The Conference Committee is formed to resolve differences between similar bills passed by the respective houses of Congress, and its narrative report describes the compromised, final provisions that were ultimately enacted by Congress.
[56] *See*, *e.g.*, PLRs 9835027, 9706014, 9630038, 9616031, and 9541019.

connection with the contribution, there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than six months after the contribution.

2. The contribution is made by a related party but no more than ten percent of the total value of the loss corporation's stock is issued in connection with the contribution, or the contribution is made by a person other than a related party, and in either case there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than one year after the contribution.

3. The contribution is made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the terms and conditions of Treas. Reg. § 1.355-7(d)(8) or (9), respectively.

4. The contribution is received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built in loss) or it is received before the first year from which there is a carryforward of a net operating loss, capital loss, excess credit, or excess foreign taxes (or in which a net unrealized built-in loss arose).

Where a loss corporation uses section 382(*l*)(6) to determine its section 382 limitation, the regulations provide that the anti-stuffing rules do not apply.[57]

(b) Redemption or Other Corporate Contraction

Section 382(e)(2) provides that, if a redemption or other corporate contraction occurs in connection with an ownership change, the value under section 382(e)(1) shall be determined after taking the redemption or other corporate contraction into account. The purpose of the adjustment is to ensure that the section 382 limitation is based on the post-change value of the loss corporation after taking into account indebtedness used to finance an acquisition (whether incurred at the loss corporation level or at a higher level) and distributions made to shareholders of the corporation. Thus, for example, a corporation contraction occurs when an entity is formed to complete an acquisition of the stock of the loss corporation, and a portion of the purchase price is financed with borrowed money.[58]

(c) Substantial Nonbusiness Assets

Section 382(*l*)(4) provides that the value of the old loss corporation must be reduced by a specified amount if, immediately after an ownership change, a new loss corporation has

[57] Treas. Reg. § 1.382-9(k)(4).
[58] Staff of Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* 288 at 316 (Comm. Print 1987). A holding company structure is most likely to invoke the corporate contraction rules when the only source for payment of principal and interest on the indebtedness is the sale of the acquired stock or a distribution from the loss corporation.

"substantial nonbusiness assets."[59] In general, a corporation has substantial nonbusiness assets if at least ⅓ of the value of the total assets of such corporation consists of nonbusiness assets.[60] For purposes of this definition, the term "nonbusiness assets" means assets held for investment.[61]

3. Adjustments for Recognized Built-in Gains

The general loss limitation rules of section 382 are adjusted when a built-in gain or loss is recognized. The built-in gain and loss rules are designed to adjust the section 382 limitation to take into account income or loss that is economically accrued prior to the ownership change but is recognized for tax purposes after the ownership change. If the corporation has a net unrealized built-in gain ("NUBIG"), any recognized built-in gain ("RBIG") taken into account during the five-year period following the ownership change date (but not in excess of the NUBIG) will increase the section 382 limitation. By contrast, if the corporation has a net unrealized built-in loss ("NUBIL"), any recognized built-in loss ("RBIL") taken into account during such five-year period (but not in excess of the NUBIL) will be treated as a pre-change loss subject to limitation under section 382.[62] A corporation will have a NUBIG or a NUBIL, as the case may be, if the difference between the aggregate basis of the corporation's assets and the aggregate fair market value of its assets is greater than a threshold amount. The threshold amount is equal to the lesser of 15 percent of the fair market value of the loss corporation's assets or $10 million.

Income or deduction items taken into account in the post-change period may be treated as RBIG or RBIL if they are "attributable to" the pre-change period.[63] The Internal Revenue Service issued Notice 2003-65,[64] which provides interim guidance, pending the issuance of final or temporary regulations, in identifying items of RBIG or RBIL. The interim guidance is particularly useful in connection with the identification of income or deduction items that are attributable to the pre-change period. The Notice sets forth two alternative approaches–the 338 approach and the 1374 approach–to assist taxpayers in making this determination. Each approach borrows liberally from the principles used in the other Code section.

In general, the 338 approach identifies items of RBIG and RBIL, including income and deduction items, by comparing the actual items recognized or incurred during the recognition period with items that would have been incurred or realized if a section 338 election had been made on the change date. A section 338 election permits certain stock acquisitions to be treated as taxable asset purchases and sales and, in general, results in the assets of the corporation being

[59] Sections 382(k)(1) through (3) define "loss corporation," "old loss corporation," and "new loss corporation," respectively. A loss corporation is, among others, a corporation that is entitled to use a net operating loss carryover to the taxable year in which the ownership change occurs. An old loss corporation means any corporation with respect to which there is an ownership change and which (before the ownership change) was a loss corporation. A new loss corporation is means a corporation which (after an ownership change) is a loss corporation. This definition clarifies that the same corporation may be both the old loss corporation and the new loss corporation.
[60] Section 382(*l*)(4)(B).
[61] Section 382(*l*)(4)(C).
[62] The NUBIG or NUBIL of a loss corporation is computed in the same manner, *i.e.*, by taking into account the fair market value of the corporation's assets based on a hypothetical sale to a single, unrelated buyer, the adjusted tax basis of those assets, and certain liabilities of the corporation that would be deductible upon payment. Treas. Reg. § 1.1374-3(a).
[63] Section 382(h)(6)(A) and (B).
[64] 2003-40 I.R.B. 747.

treated as having been purchased for an amount equal to their fair market value on such date. In the case of an actual sale or exchange of an asset held at the beginning of the recognition period, the application of the 338 approach is unlikely to produce a different result than the result that would have been obtained from a straightforward application of the statutory provisions. However, the results of applying the 338 approach will likely be different in the case of intangible assets that are not disposed of during the recognition period, but are instead used in the business of the loss corporation. If a section 338 election had been made, certain of the intangible assets of a loss corporation would be amortized over a 15-year period under the provisions of section 197. If the intangible assets have a zero basis in the hands of the loss corporation, as is frequently the case, the entire amount of this "hypothetical" amortization under the 338 approach is treated as RBIG, to the extent that it is attributable to the recognition period.

In contrast, the 1374 approach generally relies on the accrual method of tax accounting to identify income or deduction items as RBIG or RBIL, respectively.[65] In general, an item of income or deduction properly included in income or allowed as a deduction during the five-year period following the ownership change is not considered RBIG or RBIL unless an accrual method taxpayer would have included the item in income or been allowed a deduction for the item (without regard to the economic performance requirement) before the ownership change date. Notwithstanding this general standard, certain deduction attributable to depreciation, amortization, or depletion still would be treated as RBIL.[66]

If a loss corporation has a NUBIG, it is widely understood that it is more advantageous to use the 338 approach. Under that approach, as indicated above, the corporation may treat tangible and certain intangible built-in gain assets as generating RBIG even if there has been no disposition of the underlying asset. Specifically, an intangible asset, such as goodwill or going concern value that has a built-in gain on the change date is treated as if it generates income equal to the applicable cost recovery deduction that would otherwise be allowed if asset basis had been increased to fair market value (as in the case of an actual section 338 election). Thus, using section 197 as the applicable cost recovery provision, the corporation may treat $1/15^{th}$ of the value of its goodwill as RBIG for each of the five years following the change date (assuming that it has a zero basis in the absence of a section 338 election).

4. Continuity of Business Enterprise

Pursuant to section 382(c), if a loss corporation does not continue the business enterprise for two years following a change in ownership, the section 382 limitation for pre-change NOLs will be zero.[67] Congress did not set forth specific requirements for satisfaction of the continuity-of-business enterprise requirement, but instead expected that the rules would be the same as the rules that apply to corporate reorganizations. Under these rules, the corporation must continue

[65] Treas. Reg. § 1.1374-4(b).
[66] Section 382(h)(2) (which sets forth a rule for the cost recovery deductions associated with built-in loss assets that is not found in section 1374).
[67] Where section 382(*l*)(6) is applied to determine the section 382 limitation, section 382(c) applies without modification. See Treas. Reg. § 1.382-9(m)(2).

the conduct of at least one significant historic business or continue to use a significant portion of the historic business assets in a business.[68]

5. Amount of Pre-Change NOLs

Treas. Reg. § 1.382-6 provides for a default method of allocating income or loss for the taxable year which includes an ownership change, as well as an elective alternative method. Treas. Reg. § 1.382-6(a) generally permits a net operating loss for the taxable year of the change to be allocated to the two periods by ratably allocating an equal portion to each day in the year. Treas. Reg. § 1.382-6(b) permits a net operating loss for the taxable year of the change to be allocated to the two periods as if the loss corporation's books were closed on the change date.

6. Amount of Post-Change NOLs

Any net operating losses of a loss corporation that arise in a taxable year beginning after an ownership change, as well as that portion of the net operating loss for the taxable year in which a change occurs which is attributable to the post-change portion of the year, are all treated as post-change losses. Such losses are not subject to any section 382 limitation applicable to the change date, except to the extent that any loss recognized during the recognition period is treated as an RBIL.

II. TREATMENT OF INCOME FROM CANCELLATION OF INDEBTEDNESS

Income from cancellation of indebtedness often arises out of the consummation of a plan of reorganization in a federal bankruptcy case, but it can also arise from other factors, such as a contractual modification of the debt, the expiration of the statute of limitations, or the liquidation of a corporation without satisfying creditors in full. Section 108 contains special provisions for the treatment of such income, with its broadest application reserved for discharges that occur in a title 11 case or when the taxpayer is insolvent. The application of section 108 is set forth in the materials provided for use in connection with this program by Robert E. McKenzie, a co-panelist.

III. ATTRIBUTE REDUCTION FOR S CORPORATIONS

Section 108 provides for two central aspects of the treatment of income from cancellation of indebtedness. First, this provision determines whether, and to what extent, such income may be excluded from gross income. Second, this provision sets forth the consequences of such excluded income. The general provisions are modified in the case of S corporations, in view of their status as flow-through entities for federal income tax purposes.[69]

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[68] Treas. Reg. § 1.368-1(d).

[69] A third provision modifies the application of section 108(e)(6) for S corporations. *See* section 108(d)(7)(C). Although a full discussion of this provision is beyond the scope of this document, section 108(e)(6) generally provides that, if a shareholder makes a contribution to the capital of a corporation consisting of that corporation's indebtedness, the corporation will be treated as having satisfied that indebtedness for an amount equal to the shareholder's basis in the debt. The special provision for S corporations applies section 108(e)(6) by ignoring the effects of basis reductions in the indebtedness which have been used to deduct losses of a shareholder, allocated by the S corporation, after the shareholder has exhausted all available stock basis.

Under the first rule applicable to S corporations, many of the provisions of section 108 are required to be applied at the corporate level. Thus, an S corporation may exclude income from the cancellation of indebtedness only if the corporation itself is a debtor in a title 11 or similar case, or if the corporation itself is insolvent.[70] Similarly, the attribute reduction rules of section 108(b) are applied at the corporate level. However, these rules treat one shareholder-level attribute as a corporate-level attribute for purposes of these rules. If the shareholders of the S corporation have been allocated losses from the corporation that have not been deducted by the shareholders due to lack of stock or debt basis, these "suspended losses" are treated as if they were an NOL of the S corporation. Accordingly, these losses may be reduced as the result of the S corporation's realization of income from cancellation of indebtedness that is excluded under section 108(a).[71]

IV. SELECTED ISSUES INVOLVING S CORPORATIONS IN BANKRUPTCY PROCEEDINGS

One of the more interesting and evolving issues involving the relationship between the Internal Revenue Code and the Bankruptcy Code affects entities with flow-through or disregarded status for federal tax purposes. With limited exceptions, an S corporation is not subject to federal income taxes (and, in many cases, state income or franchise taxes) on its income.[72] Instead, the shareholders are subject to tax on their share of the income from the corporation. Conversely, subject to certain limitations, the shareholders are entitled to deduct their respective shares of the losses of the S corporation.

An S corporation is also permitted to own assets and conduct business through one or more qualified subchapter S subsidiaries ("QSubs").[73] A QSub is disregarded for all federal income tax purposes and, as a result, the S corporation is treated as if it directly held all of the assets and liabilities of the QSub. Thus, the S corporation also takes into account, and allocates to its shareholders, all of the items of income, deduction, loss, and credit of each of its QSubs. These provisions allow an S corporation to conduct its business in a traditional parent-subsidiary corporate form, without sacrificing the flow-through status with respect to its operations.

As a separate legal entity, an S corporation can be a debtor in a bankruptcy case even though its shareholders are not debtors. Similarly, a QSub can be a debtor in a bankruptcy case even though neither the S corporation nor its shareholders are debtors. It is conceivable that taxable gain or other income may result during the case, either from the operation of the business or from the disposition of assets. While S corporation or QSub status may be beneficial in many cases, owners of debtor entities may find it advantageous to terminate such status prior to the conclusion of the case, thus causing the entity to revert to taxable "C corporation" status.

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[70] Section 108(d)(7)(A), requiring the provisions of section 108(a) to be applied at the corporate level. This provision also reversed the holding of the Supreme Court in *Gitlitz v. Commissioner*, 531 U.S. 206 (2001). While a full discussion of this case is beyond the scope of this document, the Code (as amended following this decision) effectively provides that a shareholder of an S corporation may not treat the excluded income as tax-exempt income for the purpose of increasing the shareholder's stock basis.

[71] Further guidance on the application of this provision is set forth in Treas. Reg. § 1.108-7(d).

[72] Section 1363(a).

[73] *See* section 1361(b)(3) and Treas. Reg. §§ 1.1361-2 through -6 for guidance on the qualifications and elections for, and consequences of, QSub status.

Several cases have considered whether S corporation or QSub status is property of the estate, such that the bankruptcy court might have the power to preclude non-debtor owners from terminating such status. The genesis of this theory is the *Prudential Lines* decision, one that did not involve either S corporation or QSub status but instead involved an attempt to preserve the NOL of a debtor corporation.[74] Some background on the federal tax aspects of the case is in order.

Pursuant to section 382(g)(4)(D), if any stock held by a 50-percent shareholder is treated by such shareholder as becoming worthless during any taxable year of the shareholder and this stock is held by the shareholder as of the close of the taxable year, for purposes of determining whether an ownership change occurs after the close of the taxable year, the shareholder is treated as having acquired the stock on the first day of the first succeeding taxable year, and is not treated as having owned such stock during any prior period. Although somewhat cryptic, when it applies, this provision generally has the effect of rendering completely useless the NOLs of a corporate debtor if its 50-percent shareholder has claimed a worthless stock deduction with respect to the stock of the debtor. Congress intended the loss corporation to be treated in the same manner as if its controlling shareholder had sold the stock for its fair market value (which is usually zero or nearly zero) in lieu of treating the stock as worthless. The sale of the stock would have caused an ownership change for section 382 purposes.

In *Prudential Lines*, the debtor corporation had approximately $74 million in NOLs from pre-bankruptcy operations that were available for carrying forward to subsequent taxable years. The parent corporation attempted to claim a $39 million worthless stock deduction, which would have destroyed the value of the debtor's NOLs. Creditors of the debtor sued the parent to enjoin it from doing so. The United States Court of Appeals for the Second Circuit, affirming the Bankruptcy Court, held that the NOL was property of the estate, and that the parent corporation could be enjoined from claiming the worthless stock deduction.

The federal courts have wrestled with similar issues in the context of S corporations and QSubs that are debtors in bankruptcy cases. The most recent case appears to limit the scope of the *Prudential Lines* decision, thus permitting owners of such entities to revoke or terminate the special tax status of a debtor entity under the Internal Revenue Code without the cloud of uncertainty created by the Bankruptcy Code.

In *Majestic Star Casino LLC v. Barden Development Inc. (In re Majestic Star Casino LLC)*,[75] one of the debtors, Majestic Star Casino II, Inc. ("MSC II") was a QSub at the time it filed its chapter 11 petition. The debtors involved other entities in the controlled group, including Majestic Star Casino LLC, a higher-tier entity in the group of debtors. Its parent corporation, Barden Development, Inc. ("BDI"), was an S corporation at such time, but was not a debtor in the proceeding. After the chapter 11 petition was filed, BDI, with the consent of its shareholders, revoked its S corporation election.[76] Under applicable provisions of the Internal Revenue Code,

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[74] *Official Committee of Unsecured Creditors v. PSS Steamship Co. (In re Prudential Lines, Inc.)*, 928 F.2d 565 (2d Cir. 1991).

[75] 716 F.3d 736 (3d Cir. 2013).

[76] The petitions were filed on November 23, 2009, while the termination of the S corporation and QSub status became effective on January 1, 2010. Under applicable provisions of the Code and the regulations, the revocation of

the QSub status of MSC II also terminated because its stock was no longer owned (indirectly, in this case) by an S corporation.

Because the revocation of BDI's S corporation election was consistent with the Code and regulations, the Service accepted the revocation. After the termination of its QSub election, MSC II reverted to taxable C corporation status. The entity became obligated to the Indiana Department of Revenue for approximately $2.26 million in income taxes that it would not have been obligated to pay if it had retained its status as a QSub. Creditors sought to prevent the imposition of this tax liability by seeking an order from the Bankruptcy Court to require the defendants, including the Internal Revenue Service, to retroactively reinstate the QSub status of MSC II. The Bankruptcy Court agreed with the creditors and ordered the requested relief.[77]

On appeal, the court of appeals vacated the Bankruptcy Court's order and remanded the matter to the lower court with directions to dismiss the complaint for lack of jurisdiction.[78] Despite its determination that the standing issue was the threshold issue to be decided, the court concluded that it could not address this issue without also addressing the merits of the issue, *i.e.*, whether the tax-favored status of MSC II was "property" of the estate.

The court began its discussion by noting the evolution of the case law from the NOL cases to the S corporation status cases, and finally, to the QSub cases. Following *Prudential Lines*, courts began to hold that a debtor's S corporation status was property of the estate. The principal S corporation case is *In re Trans-Lines West, Inc.*,[79] and several cases followed its holding.[80] Nevertheless, the court expressed its concerns about the line of cases that began with *Trans-Lines West*, citing the doubts expressed by commentators in the aftermath of the case.[81] The court thus concluded that the S corporation status of a debtor is not "property" within the meaning of the Bankruptcy Code. The court then had no hesitation in concluding that the QSub status of MSC II was not "property" within the meaning of the Bankruptcy Code.

As the penultimate step in its analysis, the court determined that, even if the QSub status of MSC II could be treated as "property," it was not properly seen as property of the estate. Having reached this conclusion, the court finally circled back to the question of standing, and concluded that the debtors lacked standing to initiate an adversary proceeding to seek avoidance of the alleged "transfer" of MSC II's QSub status.

It is unlikely that *Majestic Star Casino* will be the last word on this complex issue. Other courts of appeals may be presented with the same issue involving either QSubs or S corporation status, and there is no assurance that the courts of other circuits will follow the Third Circuit's lead.

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the S corporation election could have become effective on this date only if it had been filed with the Service on or before March 15, 2010.

[77] 466 B.R. 666 (Bankr. D. Del. 2012).

[78] The court described the issue as whether the loss of the debtor's favored tax status as the result of actions of a non-debtor company was void as a post-petition transfer of property of the estate in violation of the automatic stay, or avoidable under sections 362, 549, and 550 of the Bankruptcy Code. The issue was described by the court as one of first impression for the courts of appeals.

[79] 203 B.R. 653 (Bankr. E.D. Tenn. 1996).

[80] *See*, *e.g.*, *Parker v. Saunders (In re Bakersfield Westar, Inc.)*, 226 B.R. 227 (B.A.P. 9th Cir. 1998).

[81] *See*, *e.g.*, J. Eustice and J. Kuntz, Federal Income Taxation of S Corporations ¶ 5.08[1] (4th Ed. 2001).

Internal Revenue Code § 1398 and the Bankruptcy Estate

By Lynn M. Brimer

The Bankruptcy Tax Act of 1980 (P.L. No. 96-589, 94 Stat. 3389 (1980) (the "BTA") (Codified at several sections of the Internal Revenue Code) was intended, in part, to facilitate a debtor's fresh start with respect to his or her tax obligations. The portion of the BTA codified at Internal Revenue Code Section 1398, established two significant tax features for individual debtors:

1. It provides for the establishment of a separate taxable entity when an individual files a chapter 7 or chapter 11 bankruptcy proceeding; and

2. It allows the individual chapter 7 or 11 debtor to elect to shorten his or her tax year – thus affording the individual debtor the opportunity to trap at least some of his/her tax liability for the current year in the bankruptcy estate as a priority claim under 507(a)(8). [1]

I. Separate Entity Rules and Tax Obligations

Under Section 1398 of the Internal Revenue Code, the estate of a chapter 7 or chapter 11 individual debtor is a separate taxable entity. It should be noted that a separate taxable estate is not created in any other proceeding – including a chapter 12 or 13.[2] Upon the filing of the petition, a taxable bankruptcy estate is created while the individual debtor continues as a separate taxable entity.

The chapter 7 trustee and the debtor-in-possession in an individual chapter 11 proceeding must submit a Form SS4, Application for Employer Identification Number, to the IRS in order to obtain a separate identification number for the bankruptcy estate. In the event of a chapter 11 filing by a husband and wife, the estates of the spouses are treated separately for tax purposes and therefore both spouses are required to request an employer identification number for each of their separate bankruptcy estates.

[1] Section 346 of the Bankruptcy Code makes the provisions of Section 1398 applicable to the treatment of state and local taxes.

[2] There is no separate taxable entity created by the filing of a bankruptcy petition by a partnership, corporation or member limited liability company or by an individual chapter 12 or 13 debtor. Section 1398 of the Internal Revenue Code specifically provides that "[e]xcept in any caste to which section 1398 applies, no separate taxable entity shall result from the commencement of a case under title 11 of the United States Code."

The estate is responsible for filing a Form 1041, U.S. Income Tax Return for Estates and Trusts. In the case of a chapter 7, the Trustee is required to prepare and file the Form 1041 and to pay any associated tax liabilities. In the case of an individual chapter 11, the debtor-in-possession is required to file a Form 1041 on behalf of the estate as well as a Form 1040 for non-estate income. The individual chapter 11 estate reports income on a Form 1040 but transmits the Form 1040 to the IRS via the Form 1041.

The chapter 7 trustee is required to report all gross income of the debtor that the estate is entitled to receive (i.e., a state income tax refund received by the estate would be reportable income by the chapter 7 trustee). However, the estate's gross income does not include income received directly by the debtor during the tax year prior or subsequent to the commencement of the case. Accordingly, the debtor is not required to report on his or her Form 1040 any income received by the estate that is reportable by the trustee on the estate's Form 1041.

The chapter 11 individual estate reports all income received after the filing of the petition, including earnings from services performed by the debtor after the petition date. Section 1115 of the Bankruptcy Code, specifically provides that all earnings from post-petition services provided by the debtor are property of the bankruptcy estate.[3] The estate may compensate the individual debtor from the funds received by the estate from the services performed by the debtor by payment of a management fee to the debtor for the operation of the business the debtor operated pre-petition. Such compensation would be reported by the debtor on his or her Form 1040 as miscellaneous income. The estate would be entitled to claim an administrative expense deduction for the management fee paid to the debtor.

The post-petition income of the debtor for services performed after the commencement of the case are reported by the estate on a Form 1040 submitted as an attachment to the Form 1041 filed by the estate. Moreover, if the debtor receives wages both pre- and post- petition, the estate is required to report the post-petition wages and the debtor reports the pre-petition wages on his Form 1040. The management fee paid to the debtor by the estate would be reported by the debtor as other income on his Form 1040. Furthermore, the debtor must disclose that there has been an allocation of wages between the two returns by attaching a statement to his Form 1040 indicating that the return is subject to a chapter 11

[3]Section 1115(a)(2) provides specifically that "[i]n a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541- earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first."

bankruptcy proceeding. The statement must include (1) the allocation of the wages and withholdings between the two returns; (2) a description of the methodology used for determining the allocation; and (3) the information regarding the chapter 11, including the case number, the court the case is filed in, the petition date and the estate's EIN.

The individual chapter 11 estate is entitled to claim a deduction for all expenses incurred in the operation of the debtor's business and takes credits in the same fashion the debtor would have used them had the petition not been filed. In addition, the estate is entitled to a deduction for all administrative expenses, including accounting fees, legal fees and court costs, which are reportable on Schedule A as miscellaneous deductions which are not subject to the 2% floor typically applicable to such deductions on individual return. See IRC § 67(e). Other administrative deductions incurred in the operation of the debtor's trade or business are reported on Schedules C, E, and/or F depending on the nature of the expense.

The debtor's pre-petition tax attributes pass to the estate and are used in the same fashion by the estate as they would have been used by the debtor. However, the estate cannot take advantage of any net operating loss or credit carry back generated in a tax year after the year the petition is filed. The debtor is also prohibited from carrying back prepetition net operating losses (NOLs) or credits to prepetition tax years. However, the estate can carry back any NOL or credit carryback generated by the estate to a prepetition tax year of the debtor to generate a refund for the estate.

The tax attributes, including those that arise during the course of the case, are returned to the debtor when the estate is terminated. However, an individual debtor may not claim any unused administrative losses generated by the estate.

A bankruptcy estate is required to file a Form 1041 when the estate has income above the filing threshold. For 2013, the filing threshold for a chapter 7 estate is $10,000. Estates with income below the filing threshold have no obligation to file a Form 1041.

II. Short Year Elections

Section 1398(d) allows a debtor to make a "short year" election and thereby spilt the tax year into two tax years. The first tax year runs from January 1st through the day immediately preceding the petition date. The second tax year

begins on the petition date and runs through December 31st. The election, once made, is irrevocable.

The election is made by timely filing a return for the short year indicating that it is filed pursuant to Section 1398. The return should have SECTION 1398 ELECION written across the top in bold lettering. The short year return is due on the 15th day of the fourth full month following the month in which the petition is filed. 26 U.S.C. § 6072. For example, if an individual debtor files a chapter 7 petition on March 15th, the deadline for filing the return making the election to file a short year return under Section 1398 is July 15th. The deadline for filing the short year return for the period ending December 31st remains April 15th.

The filing of the short year return renders any unpaid liability reflected on the return a prepetition priority claim against the estate under Section 507(a)(8) of the Bankruptcy Code. From a pre-filing planning perspective, this allows a debtor to treat the unpaid tax liabilities for the short year as a priority over unsecured creditors. If the election is not made the entire liability for filing year is treated as post-petition.

Tax attributes that are transferred to the estate are determined as of the close of the tax year immediately preceding the petition date. Therefore, if the debtor makes a short year election, the bankruptcy estate's tax attributes are determined as of the day immediately preceding the petition date. If the debtor does not make a short year election, the tax attributes that are transferred to the estate are determined as of December 31 of the year preceding the year of the filing.

III. Impact on Chapter 12 and 13 Debtors

By its terms, Section 1398 only applies to chapter 7 and chapter 11 debtors. Therefore, chapter 12 and 13 debtors cannot take advantage of the separate entity provision or make an election to file a short year return.

A chapter 12 or 13 debtor remains liable for any tax liability incurred by his bankruptcy estate. For example, in *Hall v. United States*,[4] Mr. and Mrs. Hall filed a chapter 12 petition and sold their family farm post-petition. The Halls incurred a tax of $29,000 on the gain from the sale. The Hall's plan initially made no provision for the payment of the tax. After the objection of the IRS to this treatment was upheld, the Hall's amended their plan to provide for treatment of

[4] *Hall v. United States*, 132 S.Ct. 1882, 182 L.Ed.2d 840 (2012)

the tax as a general unsecured claim entitled to a distribution on the $29,000 income tax to the extent funds were available. Any unpaid balance was to be discharged. The Halls relied on section 1222(a)(2)(A) of the Bankruptcy Code, which allows for the discharge of certain claims owed to governmental units entitled to priority under Section 507.[5] The Bankruptcy Court, as affirmed by the Supreme Court, concluded that the tax on the gain from the sale of the farm was not a claim under section 507 of the Bankruptcy Code and therefore could not be discharged by the Hall's chapter 12. Two subsections in Section 507 potentially applied to the Hall's capital gain. Section 507(a)(8)(A) provides that for priority treatment of certain income taxes (which the capital gain on the sale of an asset would be) "for a taxable year ending on or before the date of the filing of the petition." Since the sale occurred post-petition, Section 507(a)(8) did not apply to the gain generated by the sale of the farm. The Halls argued that the tax was an administrative claim entitled to priority under Section 507(a)(2) because the farm was sold post-petition. Section 507(a)(2) provides for priority treatment of claims allowable under Section 503(b). Section 503(b) allows administrative priority treatment for any tax "incurred by the estate." The Supreme Court concluded that because there is no separate taxable estate created by the filing of the Chapter 12 petition under Section 1398, the income tax incurred on the gain on the sale of the Hall's farm was not "incurred by the estate," and therefore was not within the scope of Section 1222(a)(2)(A).

The fact that Section 1398 is not applicable to chapter 12 and 13 debtors makes pre-petition tax planning extremely important in those situations where the debtor is contemplating the sale of an asset that may lead to a gain. Without the protection of the separate estate, the taxing authority would be free to collect the unpaid post-petition taxes from the debtor.

[5] Section 1222(a)(2)(A) provides that: "The plan shall provide- (2) for the full payment, in deferred cash payments, of all claims entitled to priority under section 507, - (A) unless the claim is a claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation, in which case the claim shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debtor shall be treated in such manner only if the debtor receives a discharge."

SECTION 1398: RULES RELATING TO INDIVIDUALS' TITLE 11 CASES
(26 U.S. C. § 1398)

(a) Cases to which Section applies. Except as provided in subsection (b), this section shall apply to any case under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of title 11 of the United States Code in which the debtor is an individual.

(b) Exceptions where case is dismissed, etc.

(1) Section does not apply where case is dismissed. This section shall not apply if the case under chapter 7 or 11 of title 11 of the United States Code is dismissed.

(2) Section does not apply at partnership level. For purposes of subsection (a), a partnership shall not be treated as an individual, but the interest in a partnership of a debtor who is an individual shall be taken into account under this section in the same manner as any other interest of the debtor.

(c) Computation and payment of tax; basic standard deduction

(1) Computation and payment of tax. Except as otherwise provided in this section, the taxable income of the estate shall be computed in the same manner as for an individual. The tax shall be computed on such taxable income and shall be paid by the trustee.

(2) Tax rates. The tax on the taxable income of the estate shall be determined under subsection (d) of section 1.

(3) Basic standard deduction. In the case of an estate which does not itemize deductions, the basic standard deduction for the estate for the taxable year shall be the same as for a married individual filing a separate return for such year.

(d) Taxable year of debtors

(1) General rule. Except as provided in paragraph (2), the taxable year of the debtor shall be determined without regard to the case under title 11 of the United States Code to which this section applies.

(2) Election to terminate debtor's year when case commences

(A) In general. Notwithstanding section 442, the debtor may (without the approval of the Secretary) elect to treat the debtor's taxable year which includes the commencement date as 2 taxable years—

(i) the first of which ends on the day before the commencement date, and
(ii) the second of which begins on the commencement date.

(B) Spouse may join in election. In the case of a married individual (within the meaning of section 7703), the spouse may elect to have the debtor's election under subparagraph (A) also apply to the spouse, but only if the debtor and the spouse file a joint return for the taxable year referred to in subparagraph (A)(i).

(C) No election where debtor has no assets. No election may be made under subparagraph (A) by a debtor who has no assets other than property which the debtor may treat as exempt property under section 552 of title 11 of the United States Code.

(D) Time for making election. An election under subparagraph (A) or (B) may be made only on or before the due date for filing the return for the taxable year referred to in subparagraph (A)(i). Any such election, once made, shall be irrevocable.

(E) Returns. A return shall be made for each of the taxable years specified in subparagraph (A).

(F) Annualization. For purposes of subsections (b), (c), and (d) of section 443, a return filed for either of the taxable years referred to in subparagraph (A) shall be treated as a return made under paragraph (1) of subsection (a) of section 443.

(3) Commencement date defined. For purposes of this subsection, the term "commencement date" means the day on which the case under

title 11 of the United States Code to which this section applies commences.

(e) Treatment of income, deductions, and credits

(1) Estate's share of debtor's income. 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 (as defined in subsection (d)(3)).

(2) Debtor's share of debtor's income. The gross income of the debtor for any taxable year shall not include any item to the extent that such item is included in the gross income of the estate by reason of paragraph (1).

(3) Rule for making determinations with respect to deductions, credits, and employment taxes. 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.

(f) Treatment of transfers between debtor and estate

(1) Transfer to estate not treated as disposition. 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.

(2) Transfer from estate to debtor not treated as disposition. 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.

(g) Estate succeeds to tax attributes of debtor. The estate shall succeed to and take into account the following items (determined as of the first day of the debtor's taxable year in which the case commences) of the debtor—

(1) Net operating loss carryovers. The net operating loss carryovers determined under section 172.

(2) Charitable contributions carryovers. The carryover of excess charitable contributions determined under section 170(d)(1).

(3) Recovery of tax benefit items. Any amount to which section 111 (relating to recovery of tax benefit items) applies.

(4) Credit carryovers, etc. The carryovers of any credit, and all other items which, but for the commencement of the case, would be required to be taken into account by the debtor with respect to any credit.

(5) Capital loss carryovers. The capital loss carryover determined under section 1212.

(6) Basis, holding period, and character of assets. In the case of any asset acquired (other than by sale or exchange) by the estate from the debtor, the basis, holding period, and character it had in the hands of the debtor.

(7) Method of accounting. The method of accounting used by the debtor.

(8) Other attributes. Other tax attributes of the debtor, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section.

(h) Administration, liquidation, and reorganization expenses; carryovers and carrybacks of certain excess expenses

(1) Administration, liquidation, and reorganization expenses. Any administrative expense allowed under section 503 of title 11of the

United States Code, and any fee or charge assessed against the estate under chapter 123 of title 28 of the United States Code, to the extent not disallowed under any other provision of this title, shall be allowed as a deduction.

(2) Carryback and carryover of excess administrative costs, etc., to estate taxable years.

(A) Deduction allowed. There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of
(i) the administrative expense carryovers to such year, plus
(ii) the administrative expense carrybacks to such year.

(B) Administrative expense loss, etc. If a net operating loss would be created or increased for any estate taxable year if section 172 (c) were applied without the modification contained in paragraph (4) of section 172 (d), then the amount of the net operating loss so created (or the amount of the increase in the net operating loss) shall be an administrative expense loss for such taxable year which shall be an administrative expense carryback to each of the 3 preceding taxable years and an administrative expense carryover to each of the 7 succeeding taxable years.

(C) Determination of amount carried to each taxable year. The portion of any administrative expense loss which may be carried to any other taxable year shall be determined under section 172(b)(2), except that for each taxable year the computation under section 172(b)(2) with respect to the net operating loss shall be made before the computation under this paragraph.

(D) Administrative expense deductions allowed only to estate. The deductions allowable under this chapter solely by reason of paragraph (1), and the deduction provided by subparagraph (A) of this paragraph, shall be allowable only to the estate.

(i) Debtor succeeds to tax attributes of estate. In the case of a termination of an estate, the debtor shall succeed to and take into account the items referred to in paragraphs (1), (2), (3), (4), (5), and (6) of subsection (g) in a manner similar to that provided in such paragraphs (but taking into account that the transfer is from the estate to the debtor instead of from the debtor to the estate). In addition, the

debtor shall succeed to and take into account the other tax attributes of the estate, to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section.

(j) Other special rules

(1) Change of accounting period without approval. Notwithstanding section 442, the estate may change its annual accounting period one time without the approval of the Secretary.

(2) Treatment of certain carrybacks

(A) Carrybacks from estate. If any carryback year of the estate is a taxable year before the estate's first taxable year, the carryback to such carryback year shall be taken into account for the debtor's taxable year corresponding to the carryback year.

(B) Carrybacks from debtor's activities. The debtor may not carry back to a taxable year before the debtor's taxable year in which the case commences any carryback from a taxable year ending after the case commences.

(C) Carryback and carryback year defined. For purposes of this paragraph—

(i) Carryback. The term "carryback" means a net operating loss carryback under section 172 or a carryback of any credit provided by part IV of subchapter A.

(ii) Carryback year. The term "carryback year" means the taxable year to which a carryback is carried.

Bankruptcy Tax Questions Answered!

by

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OVERVIEW

BAPCA

The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005. On April 20, 2005, BAPCPA became law, making fundamental changes to our consumer bankruptcy system. Most of BAPCPA's provisions became effective 180 days after the bill was signed into law, or October 17, 2005. The BAPCPA provides that:

- Debtors filing under Chapters 7, 11, 12, and 13 of the Bankruptcy Code must file all applicable federal, state, and local tax returns that become due after a case commences. Failure to file tax returns timely or obtain an extension can cause a bankruptcy petition to be converted to another Chapter or dismissed. In Chapter 13 cases, the debtor must file all required tax returns for tax periods ending within 4 years of filing the bankruptcy petition.

- The confirmation of a plan under Chapter 11 does not discharge a corporate debtor from tax debts for which the debtor filed a fraudulent return or willfully attempted to evade or defeat tax.

- In Chapter 11 cases of individuals, wages and income from self-employment earned during the bankruptcy case are property of the estate. Income that is property of the estate should be reported on the bankruptcy estate's tax return.

- Withheld taxes, taxes for which a return was not filed, taxes for which a return was untimely filed within 2 years of the bankruptcy, and taxes that the taxpayer attempted to evade or defeat are now excepted from the Chapter 13 discharge.

BEFORE THE PROCESS BEGINS - BANKRUPTCY CODE TAX COMPLIANCE REQUIREMENTS

Tax Returns Due After the Bankruptcy Filing

For all bankruptcy cases filed after October 16, 2005, 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.

Tax Returns for Tax Periods Ending Before the Petition Date in Chapter 13 Cases

For bankruptcy cases filed after October 16, 2005, 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. 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). 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.

Trustees may require the debtor to submit copies or transcripts of the debtor's returns as proof of filing.

CREATION OF THE BANKRUPTCY ESTATE

Bankruptcy proceedings begin with filing a petition in bankruptcy court, and that filing creates the bankruptcy estate. Typically an individual debtor files either a Chapter 7 or Chapter 11 Petition[1]. In all other bankruptcy proceedings, including Chapter 7 or Chapter 11 bankruptcy cases dismissed by the Bankruptcy Court, the debtor continues to file income tax returns as though there were no bankruptcy and there were no separate taxable bankruptcy estate. When a separate taxable bankruptcy estate is created, the estate inherits and considers the following **income attributes** of the debtor[2]:

1. Net operating loss carryovers determined under IRC 172.

2. Charitable contribution carryover determined under IRC 170(d)(1).

3. Recovery of tax benefit items for any amount to which IRC 111 applies.

4. Carryovers of any credit, and all other items that, except for the commencement of the bankruptcy case, the debtor would be required to take into account with respect to any credit.

5. Capital loss carryovers determined under IRC 1212.

6. The debtor's basis, holding period, and character of any asset acquired from the debtor (unless acquired by sale or exchange).

7. The debtor's accounting method.

8. Other tax attributes of the debtor, to the extent provided by regulation.

The bankruptcy estate generally comprises all of the assets of the person or entity filing the bankruptcy petition, unless property is exempt under USC 522[3]. Individual estates may opt out of the federal exemption scheme and determine what property is exempt for resident debtors. Most states have done so. Upon conclusion or dismissal of the bankruptcy proceedings, the debtor takes over any remaining tax attributes including those that first rose during administration of the bankruptcy estates[4].

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1 IRC §1398(a).
2 IRC §1398(g).
3 11 USC §541
4 11 USC §346(i)(2)

BACKGROUND AND GENERAL LEGAL PRINCIPLES

The commencement of a bankruptcy case creates an estate, which generally includes all legal or equitable interests of the debtor in property as of the commencement of the case[5]. Specific exclusions apply, however[6]. Exempt property and abandoned property are initially part of the bankruptcy estate, but are subsequently removed from the estate. Property excluded from the estate is never included in the estate.

> ***Plain Language Practice Tip!*** *Here's what's going on: The bankruptcy estate is treated as a separate taxable entity from the debtor. The trustee or debtor-in-possession is responsible for preparing and filing the estate's tax returns and paying its taxes. The debtor remains responsible for filing his or her own returns and paying taxes on income that does not belong to the estate.*
>
> *Bankruptcy law determines which of a debtor's assets become part of a bankruptcy estate. A transfer (other than by sale or exchange) of an asset from the debtor to the bankruptcy estate is not treated as a disposition for income tax purposes. Consequently, the transfer does not result in gain or loss, recapture of deductions or credits, or acceleration of income or deductions. For example, transferring an installment obligation to the estate would not accelerate gain under the rules for reporting installment sales. The estate is treated the same way the debtor would be regarding the transferred asset.*
>
> *When the bankruptcy estate is terminated or dissolved, any resulting transfer (other than by sale or exchange) of the estate's assets back to the debtor is also not treated as a disposition. The transfer does not result in gain or loss, recapture of deductions or credits, or acceleration of income or deductions to the estate.*
>
> *The abandonment of property by the estate to the debtor is a nontaxable disposition of property. If the debtor received abandoned property from the estate, the debtor has the same basis in the property that the estate had.*

Chapter 11

Confirmation of a Chapter 11 plan of reorganization vests all the property of the estate in the debtor, except as otherwise provided in the plan or in the court order confirming the plan[7]. If no plan is confirmed and a bankruptcy case is dismissed, the property of the

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5 11 U.S.C. § 541(a)(1).
6 See 11 U.S.C. § 541(b) (excluded property). See also 11 U.S.C. § 522 (exempt property); 11 U.S.C. § 554 (abandoned property).
7 11 U.S.C. § 1141(b).

estate revests in the debtor, unless the court orders otherwise[8].

Trustee or Debtor in Possession

When a trustee is appointed under section 1104 of the Bankruptcy Code, the debtor must turn over to the trustee control over the assets of the bankruptcy estate. In most Chapter 11 cases, a trustee is not appointed and the debtor (called the debtor in possession) remains in control of the property of the bankruptcy estate. Under section 1107(a) of the Bankruptcy Code, the debtor in possession must perform all the functions and duties of a trustee, except for the duties specified in Bankruptcy Code section 1106(a)(2), (3) and (4).

EIN

Because the bankruptcy estate is a separate taxable entity, the trustee or debtor in possession must obtain an employer identification number (EIN) for the estate[9]. The trustee or debtor in possession uses the EIN on any tax returns filed for the estate.

Attribution of Income

IRC Section 1398(e)(1) provides that the gross income of the estate includes the gross income of the debtor to which the estate is entitled under the Bankruptcy Code. IRC Section 1398(e)(2) provides that the gross income of the debtor does not include any item to the extent the item is included in the gross income of the bankruptcy estate.

Determination of Deduction or Credit

Determining whether any amount paid or incurred by the estate is allowable as a deduction or credit to the estate 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[10]. The estate is, however allowed a deduction for administrative expenses allowed under section 503 of the Bankruptcy Code and for any fee or charge assessed against the estate under Chapter 123 of title 28 of the United States Code. I.R.C. § 1398(h)(1).

1040s

The individual debtor must continue to file his or her own individual tax returns during the bankruptcy proceedings. I.R.C. § 6012(a)(1).

> ***Plain Language Practice Tip! – Ask what type of bankruptcy your client has entered so you know the filing requirements.***
>
> ***Individuals in Chapter 12 or 13***
>
> *The bankruptcy estate is not treated as a separate entity for tax purposes*

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8 11 U.S.C. § 349(b)(3). Notice 2006-83
9 I.R.C. § 6109.
10 I.R.C. §1398(e)(3)(A)

when an individual files a petition under Chapter 12 (Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income) or 13 (Adjustment of Debts of an Individual with Regular Income) of the Bankruptcy Code. The individual should continue to file the same federal income tax returns that were filed prior to the bankruptcy petition.

On the debtor's return, report all income received during the entire year and deduct all allowable expenses. Do not include in income any debts canceled because of the debtor's bankruptcy. To the extent the debtor has any losses, credits, or basis in property that were reduced because of canceled debt, these reductions must be included on the debtor's return.

Individuals in Chapter 7 or 11

If the debtor is an individual who files for bankruptcy under Chapter 7 or 11, the bankruptcy estate is treated as a new taxable entity, separate from the individual taxpayer.

If the debtor filed a Chapter 7 or 11 case, the debtor must file a Form 1040 for the tax year involved. The bankruptcy trustee files a Form 1041 for the bankruptcy estate.

If the debtor is in Chapter 11 bankruptcy and continues as the debtor-in-possession, the debtor must file both a Form 1040 and the Form 1041 for the bankruptcy estate (if the estate meets the return filing requirements).

Do not include on the debtor's individual income tax return the income, deductions, or credits that belong to the bankruptcy estate. Also, do not include as income on the debtor's return any debts canceled because of bankruptcy. However, the bankruptcy estate must reduce certain losses, credits, and the basis in property (to the extent of these items) by the amount of canceled debt.

If a husband and wife file a joint bankruptcy petition and their bankruptcy estates are jointly administered, their estates must be treated as two separate entities for tax purposes. Two separate tax returns must be filed (if they separately meet the filing requirements).

Changes Brought With BAPCPA

Section 321 of BAPCPA made several changes to Chapter 11. Although many of the provisions that apply to individual Chapter 11 cases now operate in a manner similar to the provisions that apply in Chapter 13 cases, section 1398 of the Internal Revenue Code has not been amended and continues to apply to individual Chapter 11 cases, but not to Chapter 13 cases. Based on section 1115 of the Bankruptcy Code, read in conjunction with section 1398(e)(1) of the Internal Revenue Code, the debtor's gross earnings from post-petition services and gross income from post-petition property are, in general, includible in the bankruptcy estate's gross income, rather than in the debtor's gross income.

Conversion to Chapter 13

If a Chapter 11 case is converted to a Chapter 13 case, the Chapter 13 estate is not a separate taxable entity and earnings from post-conversion services and income from property of the estate realized after the conversion to Chapter 13 are taxed to the debtor. I.R.C. § 1399.

Conversion to Chapter 7

If the Chapter 11 case is converted to a Chapter 7 case, section 1115 will not apply after conversion and earnings from post-conversion services will be taxed to the debtor, rather than the estate. 11 U.S.C. § 541(a)(6). In such a case, 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.

Dismissal

If a 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[11].

Taxation of Income from Property Excluded From the Estate

For Chapter 11 cases filed by individuals on or after October 17, 2005, the estate's gross income includes gross income from property held by the debtor when the case commenced ("pre-petition property"). There are certain exceptions to this general rule, however. The gross income on pre-petition property is included in the gross income of the debtor, rather than the estate, if the pre-petition property is excluded from the estate and the gross income is subject to taxation. Also, the gross income on pre-petition property is included in the gross income of the debtor, rather than the estate, after the pre-petition property is removed from the estate by exemption or abandonment.

TAXATION OF BANKRUPTCY ESTATE

A bankruptcy estate must file a separate tax return from the debtor. Form 1041 (U.S. Fiduciary Income Tax Return) is used for the estate, and it serves as a transmittal for the debtor's Form 1040 (U.S. Individual Income Tax Return). Bankruptcy begins with filing the petition, and continues until the proceeding is concluded.

The estate is entitled to one personal exemption and to the standard deduction for a married person filing separately (if the estate does not itemize deduction). Income tax rates are those for "Married Persons Filing Separately[12]." The estate does not file a tax return if its gross income is less than the amount of the standard deduction and one personal exemption[13]. Because a bankruptcy estate computes income like an individual and IRC §1398 contains no provision allowing it, a bankruptcy estate gets no deductions

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11 I.R.C. § 1398(b)(1).
12 IRC §1398(c)(2).
13 IRC §6012(a)(9))

for distributable net income.

> ***Plain Language Practice Tip! - <u>Caution</u>! -*** *Responsibility for filing Form 1041 lies with the fiduciary of the estate. That person may be your client, because it is either the trustee (if one is appointed), or the debtor in possession (<u>your</u> client, if one is not)[14].*

Tax Year

The bankruptcy estate can adopt either a calendar year or a fiscal year since it is taxed as a separate new entity[15]. In addition, the estate can change its tax year once without IRS approval. This allows the trustee to end the estate's tax year before the expected termination of the estate (usually at the conclusion of bankruptcy), and then submit a return for the short year for a prompt determination of tax liability under 11 USC §505(b). See "Request for Prompt Determination of Liability" below.

Gross Income of the Estate

The gross income of the estate includes all gross income of the debtor received or accrued after commencement of the bankruptcy proceedings and to which the estate is entitled under the bankruptcy code[16]. Any income received or accrued by the debtor before commencement of the bankruptcy proceeding is excluded from the bankruptcy estate's gross income. Accrual basis taxpayers, gross income that accrued before the commencement of the bankruptcy proceedings and was included in the debtor's gross income becomes property of the estate once the bankruptcy petition is filed. So all income earned before but paid after filing the bankruptcy petition belongs to the bankruptcy estate.

Partnership or S Corporation interests that an individual owns when then bankruptcy petition is filed become property of the estate under 11 USC §541. Neither the bankruptcy code nor IRC §1398 require a partner's or partnership's tax year to close on the date a bankruptcy petition is filed. So, it appears when a petition is filed prior to the close of the partnership's tax year, all income and loss of the partnership in that year and all the subsequent years of the bankruptcy proceedings is reported on the tax return of the bankruptcy estate. Income or loss of an S Corporation is allocated among shareholders on a pro rata basis[17]. Accordingly, the debtor and bankruptcy estate should each report a pro rata share of income or loss from the corporation in the year that the debtor files a bankruptcy petition.

Deductions, Credits, and Wages

Amounts paid or incurred by the bankruptcy estate will be allowed as a credit, deduction, or as wages if such amounts would have been similarly treated by the debtor for trades and

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14 IRC §6103(e)(5)(a).
15 Reg. §1.441-1T(b)(2).
16 IRC §1398(e)(1).
17 IRC §1366(c).

business is engaged in before the commencement of the bankruptcy[18].

Administrative Expenses

All administrative expenses allowed under 11 USC §503 and any fees or charges assessed against the estate under 28 USC Chapter 123, to the extent not allowed under any other provision are allowed as deductions by the bankruptcy estate. Administrative expenses arise after the commencement of the bankruptcy action, therefore, any accrued expenses properly deducted by the debtor before bankruptcy cannot also be deducted by the estate when paid. Because administrative expenses are limited to costs not disallowed under any other provision of this title, they are subject to the deduction disallowance rules contained in the code. Administrative expenses are those incurred to preserve the estate, and include wages, salaries, bank charges or commissions, including fees paid to attorneys and accountants for services performed subsequent to filing the bankruptcy petition.

Administrative expenses incurred but not deducted in the current year can be carried back three years and forward seven years. This rule also applies to unused current year liquidation and reorganization expenses. An expense that would be classified as an operating expense for the debtor had the debtor not been in bankruptcy, and which is also an administrative expense to the estate, could seemingly be carried over under the normal carryover rules for net operating losses. Calculation of the administrative costs carryover must be made after a separate net operating loss carryover under IRC §172(b)(2) is made. The administrative expense carryover is used after the net operating loss has been applied.

> ***Plain Language Practice Tip! - Caution! -*** *The catch is, the carrybacks and carry forwards are only available to the estate, not the debtor[19].*

Net Operating Loss Carryback

A net operating loss incurred by the estate can be carried back to the debtor's pre-bankruptcy tax years, and to previous tax years of the estate[20].

Request for Prompt Determination of Liability.

The trustee or debtor in possession can request the IRS to make prompt determination of the estate's tax liability[21]. By following Rev. Proc. 2006-24, 2006-22 I.R.B. 943, *http://www.irs.gov/irb/2006-22_IRB/ar12.html*, the bankruptcy trustee may request a determination of any unpaid tax liability incurred by the bankruptcy estate during the administration of the case by filing a tax return and a request for such a determination with the IRS. For cases filed after October 16, 2005, unless the return is fraudulent or contains a material misrepresentation, the estate, trustee, debtor, and any successor to the debtor

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18 IRC §1398(e)(3).
19 IRC §1398(a).
20 IRC §1398(j).
21 11 USC §505(b).

are discharged from liability for the tax upon payment of the tax:

1. As determined by the IRS,

2. As determined by the bankruptcy court, after the completion of the IRS examination, or

3. As shown on the return, if the IRS does not:

    a. Notify the trustee within 60 days after the request for the determination that the return has been selected for examination, or

    b. Complete the examination and notify the trustee of any tax due within 180 days after the request (or any additional time permitted by the bankruptcy court).

Plain Language Practice Tip! *Because the debtor is responsible for any unpaid tax liability of the bankruptcy estate, the debtor should urge the trustee to make the request. Tax returns filed by the trustee are, upon written request, open for inspection by the debtor*[22]*. The trustee of the estate is responsible for paying the income tax liability of the estate. The debtor can be liable for the tax, however, if the assets of the estate are not sufficient to pay the tax*[23]*.*

Abandonment of Property

The trustee can, after notice and a hearing, abandon any property of the estate that is burdensome or that is inconsequential in value and benefit to the estate[24]. The right is best used when the property has a basis below its fair market value, or when the property is subject to a nonrecourse secured claim, since the sale or transfer of the property to a creditor will produce a tax liability to the estate. It is important to note that abandonment of the property does not include abandonment of proceeds after a taxable sale or exchange.

TAXATION OF THE INDIVIDUAL DEBTORS

Short Tax Year Election

The creation of a separate taxable bankruptcy estate for individuals who file Chapter 7 or Chapter 11 petitions does not include the taxation of the individual debtor. When no separate taxable bankruptcy is created, the debtor must file tax returns as though there was no bankruptcy proceeding. However, when a separate bankruptcy estate is created under the individual Chapter 7 or Chapter 11 proceeding, the debtor can elect to close his

22 IRC §6103(3)(5)(B).
23 11 USC §505(c).
24 11 USC §554.

or her tax year on the day before the bankruptcy proceeding commences[25]. The debtor must have property other than exempt property to make the election.

If the election is not made the tax year of the debtor is not affected by the bankruptcy. The debtor will file Form 1040 (U.S. Individual Income Tax Return) for the entire year, but will only include income and deductions that accrued before the commencement of the bankruptcy, and those accruing after bankruptcy that relate to property acquired after bankruptcy or exempt property[26]. When the election is made, the debtor's tax year is divided into two short tax years:

The first starts when the debtor's tax year would have started had the election not been made (January 1st for most individuals) and ends the day before the bankruptcy petition is filed.

1. The second begins the day the bankruptcy petition is filed and ends when the debtor's tax year would have ended had the election not been made (December 31 for most individuals).

Tax computations for the first short year are collected from the bankruptcy estate because it is a liability of the debtor prior to bankruptcy. If the estate does not pay the tax it becomes collectable from the individual debtor after the bankruptcy proceeding concludes[27].

When to Elect Short Years

An individual debtor who has taxable income for the short tax year ending the day before the bankruptcy petition is filed, should make the IRC§1398(d)(2) election. The tax liability of such income would be a claim against the estate. Conversely, the debtor should not make the election if he or she has a loss for the first short year tax year because the loss would be carried over to the bankruptcy estate. By not making the election, the loss would become part of the debtor's return for the full year and could then be used to offset income earned later in the year. If the debtor had a loss for the entire year, it would become a net operating loss carryover not acquired by the bankruptcy estate and thus, available to the debtor.

The election is made by the debtor filing a tax return for the short tax year by the fifteenth day of the fourth full month following the end of the first short tax year. For example, if the debtor files bankruptcy on March 15th, the tax return for the short period between January 1 and March 14 must be filed by July 15 of that same year. The debtor's spouse makes this election by filing jointly with the debtor. The debtor should write "Section 1398 Election" across the top of the return. The debtor and spouse can also make the election by attaching a "Statement of Election" to a properly filed tax return extension, in lieu of a tax return, for the first short year. The statement must provide that the debtor, and his

25 IRC §1398(d)(2)(A).
26 IRC §1398(e)(2).
27 11 USC §523(a)(1).

spouse, if applicable, desires to close his tax year by making a Section 1398 Election[28]. An election is irrevocable. The debtor is required to annualize taxable income for each short tax year in the same manner as if a change of accounting periods has been made.

Ownership of Tax Refunds when only One Spouse Files Bankruptcy

Under Bankruptcy Code Section 541(a) and applicable case law, any IRS refunds to which the Debtor is entitled are property of the bankruptcy estate. *See In re Lock*, 329 B.R. 856 (Bankr. S.D. Ill. 2005); *see also Graver v. Illinois Dept. of Public Aid*, 64 Ill.App.3d 820 (Ill. App. Ct. 1978).

Majority View

The "majority view" regarding how tax refunds are to be allocated is based on allocating the refund in proportion to the individual spouse's contribution to that overpayment of tax. *See In re Vongchanh*, 2009 WL 1852452 (Bankr. N.D. Ill. 2009)(Indicating that the majority approach is based on either tax withholdings or earned income), *citing Kleinfeldt v. Russell (In re Kleinfeldt)*, 287 B.R. 291, 293-294 (B.A.P. 10th Cir. 2002). Under the majority view, and the Internal Revenue Service, overpayments are allocated according to the individual liability of the taxpayer. *Id.*

Another Approach

Other courts have held that IRS refunds are allocated according to withholdings, estimated taxes paid, or earned income. The Eighth Circuit held that the filing of a joint return didn't create a tenancy by the entirety under state law in a refund arising from the joint return and therefore, the refund was an asset of the debtor's estate. *In re Wetteroff*, 435 F.2d 544 (8th Cir. 1972). The Bankruptcy Court in *In* re *Hilliou*, held that because all the reported earnings were those of the debtor spouse and all the taxes were paid with amounts withheld from those earnings, the filing of a joint return was not a conveyance giving the nondebtor spouse an interest in the refund under state law. *In re Hilliou*, 38 A.F.T.R.2d 76-5254 (Bankr. E.D.Va. 1976). Thus, the entire refund was an asset of the bankruptcy estate. *Id.* This principal is also extended to community property states. The Fifth Circuit deciding a case in Texas held that an IRS refund was the sole possession of the husband were the refund claimed was derived solely from excess withholding from the husband's earnings. *See Ragan v. Commissioner*, 135 F.3d 329 (5th Cir. 1998).

Minority Approach

The "minority approach" was adopted and articulated in *In re Innis*, 331 B.R. 784 (Bankr. C.D. Ill. 2005), and applied in the unpublished opinion in *In re Vongchanh*, 2009 WL 1852452 (Bankr. N.D. Ill. 2009. Relying partly on Illinois law treating marriage as a shared partnership, these courts held that where a debtor and nondebtor spouse filed jointly, the resulting refund was presumed jointly owned and half of it became property of debtor's bankruptcy estate. *Id.* These courts focused on the Illinois Marriage Dissolution Act indicating that this presumption could be rebutted by proof of a court order enforceable

28 See Temp. Reg. §301.9100-14T(d).

between the spouses or of a prenuptial or other written pre-petition agreement allocating the refund differently. Cases since *Innis* have rejected this approach. *In re Palmer*, the Bankruptcy Court analyzed the *Innis* case and did not agree with its holding. 2011 WL 890690 (Bankr. D. Mont. 2011). *Palmer*, instead, held that the ownership of an IRS refund must be allocated according to each spouses' contribution to the overpayment. *Id. Palmer* followed the holding and reasoning of the 10th Circuit Bankruptcy Appellate Panel in the case of *In re Crowson*, 431 B.R. 484 (B.A.P. 2010), which contains a detailed analysis of how such an allocation must be determined. *Id.* A few days before *Palmer* was decided, the Massachusetts Supreme Court also disagreed with the *Innis* approach and decided with the vast majority of courts in holding that the allocation of an IRS overpayment should be determined by looking at the spouses' separate contribution to that overpayment. *Hundley v. Marsh*, 2011 Mass. LEXIS 38 (Mass. 2011).

Subsequent Bankruptcy of Spouse

The debtor's spouse who subsequently files a Chapter 7 or Chapter 11 petition in the same tax year as the debtor can make a separate election, even if the spouse earlier jointly filed with the debtor. The debtor can join the election, provided all the requirements for a joint return are satisfied. The following example illustrates the IRC §1398 Election:

1. Assume the husband and wife for calendar tax years, that a bankruptcy case involving only the husband commenced on January 15, 1993, and that a bankruptcy case involving only the wife commenced on May 10, 1993.

2. If the husband did not make an election, his tax year would not be affected; i.e., it did not terminate on January 14. If the husband made an election, his short tax year would be January 1 through January 14; his second short tax year began January 15. The tax return for his first short tax year was due on May 15. The wife could have joined the husband's election but only if they filed a joint return for the tax year January 1 through January 14.

3. The wife could have elected to terminate her tax year effective May 10. If she did, and if the husband had not made an election or if the wife had not joined in the husband's election, she would have two tax years in 1993 -- the first from January 1 through May 9, and the second from May 9 through December 31. The tax return for her short year would be due September 15, 1993. If the husband had not made an election to terminate his tax year on January 14, the husband could have joined an election by his wife, but only if they filed a joint return for the tax year January 1 through May 9. IF the husband made an election but the wife had not joined in the husband's election, the husband could not have joined in an election with the wife to terminate her tax year on May 9, since they would not have filed a joint return for such year.

4. If the wife made the election relating to her own bankruptcy case, and had joined the husband in making an election relating to his case, she would have had two additional years with respect to her 1993 income and deductions -- the second short year would have been January 15 through May 9, and the third short year would have been May 10 through December 31. The husband could have joined in the wife's election if they could have filed a joint return for the second short tax year. If

the husband joined in the wife's election, they could have filed joint returns for the short tax year ending December 31 but would not have had to do so.

CONCLUSION OF BANKRUPTCY

At the end of the bankruptcy proceedings the debtor inherits the tax attributes of the bankruptcy estate not reduced by debt discharge. Note, however, that the estate's method of accounting is not carried over to the debtor, even though the estate originally inherited the debtor's accounting method[29]. The debtor is precluded from carrying back a net operating loss occurring on a tax year ending after commencement of the bankruptcy to any pre-bankruptcy tax year[30].

INCOME FROM DISCHARGE OF INDEBTEDNESS

Once a discharge is secured the debtor must determine if the discharge results in income. A debtor usually realizes income when a debt is cancelled or forgiven, unless the forgiveness is a gift or bequest[31]. Income is realized because the forgiveness makes assets available to the debtor that were previously offset by the debt. But a debtor can exclude from gross income any debt discharged in a bankruptcy proceeding[32].

Although no income is realized from a debt discharged in bankruptcy, the excluded amount must be reflected in one of two ways. The debtor, or estate in a Chapter 7 or 11 case can either:

1. Reduce tax attributes by that amount, or

2. Elect to reduce basis in depreciable property by the excluded amount[33].

For this purpose, the debtor or estate can elect to treat as depreciable property realty held as inventory or held primarily for sale under IRC §1221(l). The amount by which basis can be reduced, however, is limited to the aggregate adjusted basis of the depreciable property at the beginning of the tax year following the tax year of the discharge[34].

Any part of the excluded amount that does not reduce basis is then applied to reduce other tax attributes.

The bankruptcy exclusion for discharged debt is closely related to exclusions for debts discharged when:

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29 IRC §1398(i).
30 IRC §1398(j)(2)(b).
31 IRC §61(a)(12).
32 IRC §108(a)(1)(a).
33 IRC §108(b).
34 IRC §108(b)(5) and 1017.

1. The taxpayer is insolvent[35], or

2. A solvent farmer's discharge of "qualified, farm indebtedness[36]."

3. A solvent taxpayer's discharge of debt on qualified depreciable real property[37].

DISCHARGE OF AN INSOLVENT DEBTOR

An insolvent debtor can exclude from gross income discharged debt up to the amount of his insolvency[38]. Insolvency equals the excess of liabilities over the fair market value of assets immediately before the debt discharge[39]. But, an insolvent debtor who is solvent following the debt discharge realizes income to the extent post-discharge assets exceed post-discharged liabilities. Excluded amounts can either reduce tax attributes or reduce depreciable assets in the same manner as in bankruptcy.

> ***Plain Language Practice Tip! - Caution! -*** *Beware of property transferred to satisfy creditors. The insolvency exception only applies to debt cancellation income and only to the extent of the debtor's insolvency. Income might result from such transactions. In a bankruptcy case, a property transfer to creditors that results in forgiveness or discharge will not create income.*

DISCHARGE OF FARM DEBT

A solvent farmer can exclude from gross income "qualified farm indebtedness" discharge incurred after April 9, 1986[40]. If the farmer is solvent, this insolvency exclusion is first applied (to the extent of the insolvency) before application of the qualified farm debt exclusion. Qualified farm indebtedness must meet two requirements:

1. The debt must have been incurred in connection with the trade or business of farming, or be secured by farm land or equipment used in the business.

2. At least 50% of aggregate gross receipts for the three tax years preceding the tax year of the discharge must be attributable to the trade or business of farming.

The discharge must be a "qualified person," that is a government agency or person not related to the debtor, that is actively and regularly engaged in lending money, and that is not the same person that sold the farmer property for which the debt was incurred. The amount of qualified farm debt excluded from income is limited to the combined total of adjusted tax attributes and the aggregate adjusted basis in qualified property as at the beginning of the tax year following the tax year of discharge. Qualified property is any

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35 IRC 108(a)(1)(b),
36 IRC 108(a)(1)(c).
37 IRC §108(c)(1)(d).
38 IRC §108(a)(3).
39 IRC §108(a)(1)(b), (a)(3) and (b)(3).
40 IRC §108(a)(1)(c) and (g).

property used or held for use in trade or business or investment property[41]. In case of an insolvent farmer, the adjusted basis of qualified property and adjusted tax attributes are determined after any reduction on the amount of the exclusion related to insolvency.

NO DEBT DISCHARGE INCOME ON SOME REAL ESTATE DEBT

The 1993 tax law bailed out some individual taxpayers who would otherwise have debt discharge income due to a decline in the value of business realty securing the debt[42]. Previously, a taxpayer whose debt was reduced or discharged had cancellation of debt (COD) income unless the taxpayer was insolvent or was involved in a Title 11 bankruptcy proceeding, the debt was qualified farm debt, or the debt was held by the property's seller. Under the 1993 law, taxpayers can elect to exclude income from a discharge of qualifying realty debt after 1992; the excluded COD income reduces the taxpayer's basis in depreciable real property.

The exclusion only applies to the forgiveness of debt on trade or business realty. The excluded COD income is limited to the amount by which the debt (before discharge exceeds the property's FMV, and cannot be more than the taxpayer's total basis in depreciable realty. The debt must have been incurred or assumed by the taxpayer for real property used in a trade or business, and must be secured by that property. Debt incurred or assumed after 1992 only qualifies if it is used to buy, build, or substantially improve trade or business realty that secures it, or to refinance existing qualified debt (to the extent of the unpaid balance of the old debt.

> ***Plain Language Practice Tip!*** *The term "trade or business" should be broad enough to include many rental income properties. Here are two definitions that help interpret this material:*
>
> - ***Basis reduction:*** *The amount of excluded COD income reduces the basis in the taxpayer's business realty using the rules of CODE Sec. 1017, as modified by the new law. If the taxpayer disposes of the property before the end of the tax year in which the debt was discharged, the basis is reduced immediately before the disposition.*
>
> - ***Disposition of Property.*** *If the basis of depreciable realty is reduced due to the new COD exclusion and the property later is sold, the basis reduction is treated as if it had been claimed as depreciation for purposes of the Code Sec. 1250 recapture rules (however, it is not figured into the calculation of the amount by which actual depreciation claimed exceeds straight line depreciation).*

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41 IRC §108(g)(3)(a)(c), and 1017(b)(4).
42 IRC §108(a)(1)(d)

Plain Language Practice Tip! COORDINATION OF EXCLUSIONS

- *For the exclusions the bankruptcy rules take precedence over the insolvency rules*
- *The insolvency rules take precedence over the rules for qualified farm debt and the qualified real property business exclusion*
- *The insolvency exclusion, qualified farm debt exclusion, and the qualified real property exclusion do not apply to a discharge that occurs in bankruptcy*
- *The insolvency exclusion is applied first before applying the qualified debt exclusion*[43]*.*
- *The principal residence exclusion takes precedence over the insolvency exclusion, unless otherwise elected*[44]*.*

REDUCTION OF DEBTOR'S TAX ATTRIBUTES

The amount of discharge debt excluded from income reduces the debtor's or estate's tax attributes in the following order:

1. Net operating losses and carryovers. This applies to any net operating loss for, and any net operating loss carryover to the discharge's tax year.
2. General business credit carryovers. This includes any carryover to and from the discharge's tax year of:
    a. IRC §30 -- credit for increasing research activities, or
    b. IRC §38 -- general business credit.
3. Capital losses and carryovers. This includes any capital loss for the discharge's tax year and any capital loss carryover under IRC §1212 of the discharge year.
4. Reduction of asset basis. The debtor's basis in depreciable and non-depreciable assets are reduced only to the extent it exceeds the amount of liabilities after discharge.
5. Foreign tax credit carryovers. This includes any carryovers of foreign tax credit to and from the discharge's taxable year[45].

The net operating loss, capital losses, and carryovers, and the basis of depreciable

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43 IRC §108(a)(2).
44 IRC section 108(a)(2)(C).
45 IRC §108(b)(32).

property are reduced on a dollar for dollar basis. Credit carryovers are reduced at a rate of 33 cents for each dollar of discharge[46].

Order of Reduction

The reduction in each category of carryovers is made in the order of tax years in which items would be used, determined as if the discharge debt amount were included in income. The net operating losses are followed by carryovers in the order in which they arose. Investment credit carryovers are reduced on a FIFO basis. Other credit carryovers are reduced in the order they would be used against taxable income. All reductions are made after the tax for the discharge year is computed. Income limits on the use of credits are disregarded[47].

Except for the reduction of assets each of the above the categories must be reduced to zero before any remaining amount reduces the next category. Some, or all, of the discharged debt amount may remain after reduction of the first three categories of the tax attributes listed above. If so, the remaining discharge debt amount applies to reduce the basis of the taxpayer's assets held by the debtor at the beginning of the tax year after the discharge's taxable year. This amount cannot exceed the amount by which the basis in all assets (depreciable and non-depreciable) held by the debtor immediately after the discharge exceeds the amount of the debtors remain on discharge liabilities[48].

Specifics of Making the Reduction

Unless the debtor uses all or a part of the amount of canceled debt to first reduce the basis of depreciable property, use the amount of canceled debt to reduce the tax attributes in the order listed below:

- ***Net operating loss.*** Reduce any NOL for the tax year in which the debt cancellation takes place, and any NOL carryover to that tax year.
- ***General business credit carryovers.*** Reduce any carryovers, to or from the tax year of the debt cancellation, of amounts used to determine the general business credit.
- ***Minimum tax credit.*** Reduce any minimum tax credit available as of the beginning of the tax year following the tax year of the debt cancellation.
- ***Capital losses.*** Reduce any net capital loss for the tax year of the debt cancellation, and any capital loss carryover to that year.
- ***Basis.*** This reduction applies to the basis of both depreciable and non-depreciable property.

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46 IRC §108(b)(3).
47 IRC §108(B)(4).
48 IRC §1017(b)(3).

- ***Passive activity loss and credit carryovers.*** Reduce any passive activity loss or credit carryover from the tax year of the debt cancellation.

- ***Foreign tax credit.*** Last, reduce any carryover, to or from the tax year of the debt cancellation, of an amount used to determine the foreign tax credit or the Puerto Rico and possession tax credit.

Making the Reduction

Make the required reductions in tax attributes after figuring the tax for the tax year of the debt cancellation. In reducing NOLs and capital losses, first reduce the loss for the tax year of the debt cancellation, and then any loss carryovers to that year in the order of the tax years from which the carryovers arose, starting with the earliest year. Make the reductions of credit carryovers in the order in which the carryovers are considered for the tax year of the debt cancellation.

Individuals Under Chapter 7 or 11

In an individual bankruptcy under chapter 7 or 11 of title 11, the required reduction of tax attributes must be made to the attributes of the bankruptcy estate, a separate taxable entity resulting from filing the case. Also, the trustee of the bankruptcy estate must make the choice of whether to reduce the basis of depreciable property first before reducing other tax attributes.

Basis Reduction

The following rules apply to the extent indicated when any amount of the debt cancellation is used to reduce the basis of assets.

When to Make the Basis Reduction

Reductions in basis due to debt cancellation are made at the beginning of the tax year following the cancellation. The reduction applies to property held at that time[49].

Bankruptcy and Insolvency Reduction Limit

The reduction in basis for canceled debt in bankruptcy or in insolvency cannot be more than the total basis of property held immediately after the debt cancellation, minus the total liabilities immediately after the cancellation. This limit does not apply if an election is made to reduce basis before reducing other attributes.

Exempt Property Under Title 11

If debt is canceled in a bankruptcy case under title 11 of the United States Code, do not reduce the basis in property that the debtor treats as exempt property under section 522 of title 11.

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49 See Regulations section 1.1017-1 for more information.

Election to Reduce Basis in Depreciable Property First

The estate, in the case of an individual bankruptcy under chapter 7 or 11, may choose to reduce the basis of depreciable property before reducing any other tax attributes. However, this reduction of the basis of depreciable property cannot be more than the total basis of depreciable property held at the beginning of the tax year following the tax year of the debt cancellation.

Depreciable property means any property subject to depreciation, but only if a reduction of basis will reduce the amount of depreciation or amortization otherwise allowable for the period immediately following the basis reduction. The debtor may treat as depreciable property any real property that is stock in trade or is held primarily for sale to customers in the ordinary course of trade or business. The debtor must generally make this choice on the tax return for the tax year of the debt cancellation, and, once made, the debtor can only revoke it with IRS approval. However, if the debtor establishes reasonable cause, the debtor may make the choice with an amended return or claim for refund or credit.

Making Elections

Make the election to reduce the basis of depreciable property before reducing other tax attributes, and the election to treat real property inventory as depreciable property, on Form 982.

Recapture of Basis Reductions

If any basis in property is reduced under these provisions and is later sold or otherwise disposed of at a gain, the part of the gain corresponding to the basis reduction is taxable as ordinary income. Figure the ordinary income part by treating the amount of the basis reduction as a depreciation deduction and by treating any such basis-reduced property not already either IRC section 1245 or IRC section 1250 property as IRC section 1245 property. In the case of IRC section 1250 property, determine what would have been straight line depreciation as though there had been no basis reduction for debt cancellation.

Tax Attribute Reduction Example

> Tom Smith is in financial difficulty, but he has avoided declaring bankruptcy. In 2007, he agreed with his creditors whereby they agreed to forgive $10,000 of the total he owed them in return for his setting up a schedule for repayment of the rest of his debts.
>
> Immediately before the debt cancellation, Tom's liabilities totaled $120,000 and the FMV of his assets was $100,000 (his total basis in all these assets was $90,000). At the time of the debt cancellation, he was insolvent by $20,000. He can exclude from income the entire $10,000 debt cancellation because it was not more than the amount by which he was insolvent.
>
> Among Tom's assets, the only depreciable asset is a rental condominium with an adjusted basis of $50,000. Of this, $10,000 is allocable to the land, leaving a depreciable basis of $40,000. He has a long-term capital loss carryover to 2008 of

$5,000. He also has an NOL of $2,000 and a $3,000 NOL carryover from 2005. He has no other tax attributes arising from the current tax year or carried to this year.

Ordinarily, in applying the $10,000 debt cancellation amount to reduce tax attributes, Tom would first reduce his $2,000 NOL, next, his $3,000 NOL carryover from 2005, and then his $5,000 net capital loss carryover. However, he figures it is better for him to preserve his loss carryovers for the next tax year.

Tom elects to reduce basis first. He can reduce the depreciable basis of his rental condominium (his only depreciable asset) by $10,000. The tax effect of doing this will be to reduce his depreciation deductions for years following the year of the debt cancellation. However, if he later sells the condominium at a gain, the part of the gain from the basis reduction will be taxable as ordinary income.

Tom must file Form 982 with his individual return (Form 1040) for the tax year of the debt discharge. In addition, he must attach a statement describing the debt cancellation transaction and identifying the property to which the basis reduction applies.

Plain Language Practice Tip! *Before deciding whether to reduce tax attributes or to reduce basis, the debtor should review his situation remembering the following:*

1. *If taxable income is anticipated in the near future, it is usually best to reduce depreciable property and preserve operating loss and credit carryovers so as to offset taxable income and taxes while increasing cash flow.*

2. *If net operating loss carryovers and net credit carryovers will expire on you, it is usually best to reduce these tax attributes instead of losing them.*

3. *If depreciable property that might be reduced will be held for a long period of time, it is usually best to reduce depreciable property and defer any tax consequences.*

4. *If the sale of a bankrupt corporation is planned, the basis reduction might be preferable instead of a tax attribute reduction for long term deferral and a saving of tax attributes that might be the main consideration of the sale.*

5. *State and local taxes should be tested under each alternative to maximize opportunities.*

TAX LIABILITIES AND BANKRUPTCY

Bankruptcy Court Jurisdiction

Generally, the bankruptcy court has authority to determine the amount or legality of any tax imposed on the debtor or the estate, including any fine, penalty, or addition to tax, whether

or not the tax was previously assessed or paid.

The bankruptcy court does not have authority:

1. to determine the amount or legality of a tax, fine, penalty, or addition to tax that was contested before and adjudicated by a court or administrative tribunal of competent jurisdiction before the date of filing the bankruptcy petition, or

2. to decide the right of the bankruptcy estate to a tax refund until the trustee properly requests the refund from the IRS and one of the following occurs:

    - The IRS makes a determination about the refund,
    - 120 days have passed since the date of the trustee's request, or
    - A determination has been made by a governmental unit of such requests.

Tax Court Jurisdiction

Filing a bankruptcy petition automatically results in a stay against the commencement or continuation of certain Tax Court proceedings concerning the debtor. If the debtor is an individual and the bankruptcy case was filed after October 16, 2005, the scope of the stay varies depending on whether the debtor is an individual or a corporation. If the debtor is an individual and the bankruptcy case was filed after October 16, 2005, the stay prohibits the commencement of a Tax Court case concerning liabilities of the debtor for tax periods that ended before the bankruptcy order for relief (the date of filing the bankruptcy petition in voluntary cases).

Because the bankruptcy court has the power to lift the stay and allow the debtor to begin or continue a Tax Court case, the bankruptcy court has during the pendency of the stay, the sole authority to determine whether the tax issue is decided in bankruptcy court or in Tax Court.

Suspension of Time for Filing

In any bankruptcy case, the 90-day period for filing a Tax Court petition, after the issuance of the statutory notice of deficiency, is suspended for the time the debtor is prevented from filing the petition because of the bankruptcy case, and for an additional 60 days thereafter. This means that if the statutory notice was issued before the bankruptcy petition was filed, and the 90-day period had not expired, the running of the 90-day period will be suspended while the stay prevents the commencement of the Tax Court case. The 90-day period will begin to run again 60 days after the stay against filing the petition ends. The suspension exists if any part of the 90-day period remained at the date the bankruptcy petition was filed. The 90-day period for filing a Tax Court petition after issuance of a Notice of Determination in an innocent spouse case, however, is not suspended by the filing of a bankruptcy petition. If the IRS issues a final notice of determination denying the debtor's request for innocent spouse relief during the bankruptcy case, the debtor is prohibited from

petitioning the Tax Court while the automatic stay is in effect. However, the 90-day period for petitioning the Tax Court is not suspended. The debtor must ask the bankruptcy court to lift the automatic stay before petitioning the Tax Court.

Trustee May Intervene

The trustee of a bankruptcy estate in any title 11 bankruptcy case may intervene, for the estate, in any proceeding in the Tax Court to which the debtor is a party.

Tax Assessment

The automatic stay rules prevent a creditor from taking actions to collect pre-petition debts. However, the automatic stay does not apply to:

1. An audit to determine tax liability,
2. A demand for tax returns,
3. Issuing a notice of deficiency to the debtor, or
4. Making an assessment for any tax and sending a notice and demand for payment of the tax assessed (for bankruptcy cases filed after August 17, 2005).

Any tax lien that attaches to the estate's property because of an assessment described above can only take effect when the property (or its proceeds) is transferred back to the debtor. Also, the tax must be the debtor's debt that will not be discharged in the case.

Payment of Tax Claim

After filing of a bankruptcy petition and during the period the debtor's assets or those of the bankruptcy estate are under the jurisdiction of the bankruptcy court, assets in the bankruptcy estate are not subject to levy. The IRS may file a proof of claim in the bankruptcy court the same way as other creditors. This claim may be filed in the bankruptcy court even though the taxes have not yet been assessed or are subject to a Tax Court proceeding.

Secured Tax Claims

If the IRS filed a notice of federal tax lien before the bankruptcy petition was filed, the IRS will have a secured claim to the extent the lien attached to equity in the debtor's assets and will be treated as such in the bankruptcy case. In Chapter 7 cases, the trustee may be able to subordinate the tax lien to some extent to pay certain non-tax priority claims. For Chapter 11 cases filed after October 16, 2005, if the secured claim would otherwise have been entitled to treatment as a priority claim, the Chapter 11 plan must provide for the secured tax claim in the same manner and over the same period as an unsecured eighth priority tax claim.

Eighth Priority Taxes

In bankruptcy, the debtor's debts are assigned priorities for payment. Certain tax debts that arose before the bankruptcy case was filed are classified as eighth priority claims. The following federal taxes, if unsecured, are eighth priority taxes of the government:

1. Income taxes on or measured by income or gross receipts for a tax year ending on or before the date of filing of the petition for which a return, if required, is last due, including extensions, after 3 years before the date of filing of the bankruptcy petition.

2. Income taxes on or measured by income or gross receipts assessed within 240 days before the date of filing the petition. The 240-day period is exclusive of any time during which an offer in compromise for that tax was pending or in effect during that 240-day period plus 30 days, and exclusive of any time during which a stay of proceedings against collections was in effect in a prior case during the 240-day period plus 90 days.

3. Income taxes that were not assessed before the bankruptcy petition date, but were assessable as of the petition date, unless these taxes were still assessable solely because no return was filed, a late return was filed within 2 years of filing the bankruptcy petition, a fraudulent return was filed, or because the debtor willfully attempted to evade or defeat the tax.

4. Withholding taxes that were incurred in any capacity.

5. Employer's share of employment taxes on wages, salaries, or commissions (including vacation, severance, and sick leave pay) paid as priority claims under 11 U.S.C. 507(a)(4), or for which a return was last due within 3 years of filing the bankruptcy petition, including a return for which an extension of the filing date was obtained.

6. Excise taxes on transactions occurring before the date of filing the bankruptcy petition, for which a return, if required, is last due (including extensions) within 3 years of filing the bankruptcy petition. If a return is not required, these excise taxes include only those on transactions occurring during the 3 years immediately before the date of filing the petition.

Priority of Payment

For a Chapter 7 case, the preceding eighth priority taxes may be paid out of the assets of the bankruptcy estate to the extent there are assets remaining after paying the claims of secured creditors and other creditors having higher priority claims. Different rules apply to payment of eighth priority pre-petition taxes under Chapters 11, 12, and 13:

1. For Chapter 11 cases filed before October 17, 2005, a Chapter 11 plan can provide for payment of these taxes, with post-confirmation interest, over a period of 6 years from the date the taxes were assessed. For Chapter 11 cases filed after October 16, 2005, a Chapter 11 plan can provide for payment of these taxes, with post-confirmation interest, over a period of 5 years from the date of the bankruptcy order

for relief (the bankruptcy petition date in voluntary cases), in a manner not less favorable than the most favored non-priority claims (except for convenience claims under section 1122(b) of the Bankruptcy Code).

2. In Chapter 12, the debtor can pay such tax claims in deferred cash payments over time, except that for cases filed on or after April 20, 2005, certain priority taxes may be paid as general unsecured claims if they result from the disposition of a farm asset if the debtor receives discharge, and

3. In Chapter 13, the debtor can pay such taxes over 3 years (or over 5 years with court approval).

Certain taxes are assigned a higher priority for payment. Taxes incurred during administration by the bankruptcy estate are given second priority treatment, as administrative expenses. Taxes arising in the ordinary course of your business or financial affairs in an involuntary bankruptcy case, after filing the bankruptcy petition but before the earlier of the appointment of a trustee or the order for relief, are included in the third priority payment category. If you have employees, your employees' portion of employment taxes on the first $10,950 (this amount adjusted every 3 years) of wages they earned during the 180-day period before the date of your bankruptcy filing or the cessation of your business (whichever occurs first) is given fourth priority treatment. Your portion of the employment taxes on these wages, as the employer, is given eighth priority treatment.

Relief from Certain Penalties

A penalty for failure to pay tax, including failure to pay estimated tax, will not be imposed for any period during which a bankruptcy case is pending, under the following conditions. If the tax was incurred by the bankruptcy estate, the penalty will not be imposed if the failure to pay resulted from an order of the court finding probable insufficiency of funds of the estate to pay administrative expenses. If the tax was incurred by you as the debtor, the penalty will not be imposed if:

1. The tax was incurred before the earlier of the order for relief or (in an involuntary case) the appointment of a trustee, and

2. The bankruptcy petition was filed before the due date for the tax return (including extensions) or the date for imposing the penalty occurs on or after the day the bankruptcy petition was filed.

This relief from the failure-to-pay penalty does not apply to any penalty for failure to pay or deposit tax withheld or collected from others and required to be paid over to the U.S. government. Nor does it apply to any penalty for failure to timely file a return.

FUTA Credit

An employer is generally allowed a credit against FUTA for contributions made to a state unemployment fund, if the contributions are paid by the last day for filing an unemployment tax return for the tax year. If the contributions to the state fund are paid after that date, the credit shall not exceed 90% of the otherwise allowable credit that may be taken against FUTA. However, for any unemployment tax on wages paid by the trustee of a title 11

bankruptcy estate, if the failure to pay the state unemployment contributions on time was without fault by the trustee, 100% of the credit is allowed.

Statute of Limitations for Collection

In a bankruptcy case, the period of limitations for collection of tax (generally, 10 years from the date of assessment) is suspended for the period during which the IRS is prohibited from collecting, plus 6 months thereafter.

Discharge of Unpaid Tax

If you are a debtor in a bankruptcy case, the bankruptcy court may enter an order providing you with a discharge of debts. However, not all of your debts may be discharged. The scope of the bankruptcy discharge depends on the Chapter you are in and the nature of the debt. Many tax debts are excepted from the bankruptcy discharge.

If you are an individual under Chapter 7, the following tax debts, including interest, are not subject to discharge: taxes entitled to eighth priority, taxes for which no return was filed, taxes for which a return was filed late after 2 years before the bankruptcy petition was filed, taxes for which a fraudulent return was filed, and taxes that you willfully attempted to evade or defeat. Penalties in a Chapter 7 case are dischargeable unless the event that gave rise to the penalty occurred within 3 years of the bankruptcy and the penalty relates to a tax that is not discharged. Corporations and other entities that are not individuals do not receive a discharge in Chapter 7 cases.

The same exceptions to discharge that apply to individuals in Chapter 7 cases apply to individuals in Chapter 11 cases. Different rules apply for corporations. A corporation in Chapter 11 may receive a broad discharge when the plan is confirmed, but secured and priority claims must be satisfied under the plan and there is an exception to discharge for taxes for which the debtor filed a fraudulent return or willfully attempted to evade or defeat, for bankruptcy cases filed after October 16, 2005.

There are two types of discharge for individuals in Chapter 13. A debtor who completes payments under the Chapter 13 plan may receive a broad Chapter 13 discharge of the debts provided for in the plan. However, priority tax claims must be paid in full under the Chapter 13 plan, and for Chapter 13 cases filed after October 16, 2005, the following taxes are excepted from the broad Chapter 13 discharge: withholding taxes for which you are liable in any capacity, taxes for which no return was filed, taxes for which a return was filed late after 2 years before the bankruptcy petition was filed, taxes for which a fraudulent return was filed, and taxes that the debtor willfully attempted to evade or defeat. Further, for cases filed after October 16, 2005, there is an exception from discharge for debts where the creditor, including the IRS, did not receive notice of the Chapter 13 case in time to file a claim.

A debtor that does not complete payment under a Chapter 13 plan may, in some cases, be entitled to a discharge, but all the exceptions to discharge for individuals in Chapter 7 cases would apply. The Chapter 7 discharge exceptions also apply to individuals in Chapter 12. The discharge for non-individuals in Chapter 12 is similar to the pre-October 17, 2005, broad discharge an individual receives in Chapter 13.

If a tax is discharged, the discharged tax may still be collectable from the debtor's pre-bankruptcy property if the IRS filed a Notice of Federal Tax Lien before the bankruptcy petition was filed. This is because perfected liens generally pass through bankruptcy unaffected, even if the debtor's personal liability for the debt is discharged. If the IRS did not file a Notice of Federal Tax Lien before the bankruptcy petition was filed, the tax lien will generally be removed from the debtor's pre-bankruptcy property as a result of the bankruptcy, even if the debtor exempted the property out of the bankruptcy estate. However, the tax lien that arises when a tax is assessed may not be removed if the property was excluded from the bankruptcy estate, even if a Notice of Federal Tax Lien was not filed, and never became estate property.

EXHIBIT – CLASSIFYING YOUR TAX DEBT

If…	Your Tax Debt is…
All of the following are true: • the tax year for which you owe taxes ended more than three years before the date you plan to file your bankruptcy case • you properly filed your tax return (if the IRS filed a Substitute for Return for you, it doesn't count unless you agreed and signed the substitute return for the year in question at least two years before filing for bankruptcy) • the IRS has not assessed the taxes against you within 240 days before you plan to file your bankruptcy case, and • the IRS has not recorded a Notice of Federal Tax Lien with your county land records office.	**Dischargeable**, meaning you can completely eliminate your income tax debt, and the interest and penalties associated with it.
The IRS has recorded a Notice of Federal Tax Lien.	**Secured**, meaning you may be able to discharge your personal liability in bankruptcy, but the lien remains. If you don't pay off the entire debt during your case, the IRS can seize property you owned before filing to cover the rest. Practically speaking, the IRS looks to collect from real estate and retirement plans.
Your tax debt is not dischargeable or secured.	**Priority**, which means that it must be paid in full in your Chapter 13 plan.
Both of the following are true: • your tax debt is not dischargeable or secured, and • the IRS has recorded a Notice of Federal Tax Lien, but your property won't cover what you owe to IRS	**Undersecured** (if you have no seizable assets) or partially undersecured (if you have some). The undersecured portion is dischargeable if the first three conditions listed above for dischargeable taxes are met.

EXHIBIT - DISCHARGEABILITY AT A GLANCE

CHECKLIST NO. 1

DISCHARGEABILITY AT A GLANCE

PERSONAL INCOME TAXES

CHAPTERS 7 & 13

Personal income taxes are dischargeable (wiped out) in a Chapter 7 if each of the following elements exist:

1. The tax year in question is more than three years prior to filing the bankruptcy;

2. The tax in question has been assessed more than 240 days prior to filing the bankruptcy;

3. The tax return for the year in question was filed at least more than two years prior to the bankruptcy filing;

4. The tax return in question was non fraudulent and there is no showing of willful evasion of payment of a lawful tax;

5. The claim is unsecured; (If secured, the tax is discharged as to the debtor personally (in personam liability) but the lien is still valid as to any property it has attached to (in rem liability).

EXHIBIT – PAYROLL WITHHOLDING TAXES

CHECKLIST NO. 2

PAYROLL WITHHOLDING TAXES

CHAPTERS 7 & 13

Payroll withholding taxes are never dischargeable (wiped out) in a Chapter 7 (unless, of course, there are assets in the estate to liquidate and pay the claim). However, the question of whether or not the debtor is or is not the responsible officer and thus personally liable for the 100% penalty is a matter the bankruptcy court has jurisdiction to determine. And the court has jurisdiction to determine the amount of the claim, unless it has already been adjudicated by a prior court of competent jurisdiction (i.e. the tax court).

EXHIBIT – SALES TAXES

CHECKLIST NO. 3

SALES TAXES

CHAPTERS 7 and 13

If the sales tax is a true sales tax (a tax imposed on the buyer and computed based on the amount of the purchase, where the tax is to be collected by the retailer and forwarded to the taxing entity) most courts hold that it is a nondischargeable trust fund tax.

Where, however, the sales tax is actually an excise tax (a tax imposed on the retailer for the privilege of doing business, computed on the amount of the purchase) it is dischargeable if the event on which the tax arose is more than three years prior to the filing of the bankruptcy. It is important to note that what is called a sales tax in some states is actually an excise tax under bankruptcy law (such as, for example, California's so called sales tax). The dischargeability of the tax does not depend on what it is called by the state, but rather by the actual nature of the tax as determined by the bankruptcy court.

Note that where in a Chapter 13 the taxing entity fails to file a timely proof of claim and the claim is unsecured, it is discharged.

EXHIBIT – EMPLOYMENT TAXES

CHECKLIST NO. 4

EMPLOYMENT TAXES

CHAPTERS 7 and 13

The employment tax (the employer's contribution to the payroll withholding) is dischargeable under certain circumstances. Such taxes may be dischargeable if over three years old, or if over 90 days old, or entirely dischargeable, depending on how the Bankruptcy Code is interpreted. Scarce case law leaves this issue unsettled. The one case extant which deals with this issue held that any such tax over 90 days old prior to bankruptcy is dischargeable. However, Collier's on Bankruptcy makes a flat statement that such taxes are dischargeable only if over 3 years old, without citing authority.

EXHIBIT – DISCHARGEABILITY AT A GLANCE PENALTIES

CHECKLIST NO. 5

DISCHARGEABILITY AT A GLANCE

PENALTIES

CHAPTERS 7 & 13

The majority rule is that penalties that are punitive in nature only (which includes most penalties such as penalties for non filing, late filing, non payment, late payment, etc.) are dischargeable if:

1. The penalty is attached to a tax which is dischargeable; or

2. The transaction or event giving rise to the penalty is more than three years before the bankruptcy filing.

A non dischargeable penalty is one which is for reimbursement to the taxing entity for pecuniary loss, or is a penalty that represents the actual tax owed, such as the 100% penalty for payroll withholding. The typical penalties assessed against taxpayers are not in these categories.

Note: The 240 day assessment period is not applicable to tax penalties. Hence, it makes no difference when the penalty was assessed, as long as it meets one of the two criteria listed above it is dischargeable.

Note: The minority rule is that a penalty is dischargeable only if the tax is dischargeable, regardless of how old the penalty is.

Note: Penalties, even in Chapter 7, are not priority claims, but are included in exceptions to discharge under § 507.

SOURCE: "KING'S DISCHARGING TAXES
UNDER THE BANKRUPTCY REFORM ACT OF 2005"

CHAPTERS 7, 11 AND 13

MORGAN D. KING J.D

HTTP://WWW.BANKRUPTCYBOOKS.COM/DISCHARGING.HTML

(925) 829-6460

Cancellation of Debt - Insolvency

Debtor IVA DREAMY ID#

Tax year 2010

Cancelled Debt	Creditor	Amount
FORM 1099-C:	AURORA MORTGAGE SERVICES	220,000
FORM 1099-C:	HONDA MOTORS	18,350
FORM 1099-C:	CHASE BANK	37,452
	A. Total Cancelled Debt	$ 275,802

Date of Cancellation and Valuation of Assets/Liabilities July 15, 2010

Assets	
Cash - checking accounts	240
Cash - savings accounts	
Certificates of deposit	
Securities (stocks, bonds, mutual funds)	21,630
Notes and contracts receivable	
Life insurance (cash surrender value)	
Personal property (art, jewelry, etc.)	3,000
Retirement funds (IRAs, 401(k), etc.)	25,800
Automobile #1	2,500
Automobile #2	
Business assets (machinery & equipment)	
Real estate (market value)	250,000
Other assets (specify)	
PERSONAL RESIDENCE	675,000
B. Total Assets	$ 978,170

Liabilities	
Current debt (credit cards, accounts)	
Notes payable	
Auto loans payable	
Education, student loans	
Taxes payable	96,450
Real estate mortgages	
Other liabilities (specify)	
AURORA MORTGAGE (1)	220,000
AURORA MORTGAGE (2)	95,000
AURORA MORTGAGE (3)	189,400
CITIBANK MORTGAGE SERVICE	300,000
CITIBANK EQUITYLINE	240,000
CREDIT CARD DEBT	88,000
C. Total Liabilities	$ 1,228,850
D. Amount of Insolvency (C - B, NOT < 0)	$ 250,680
E. Amount excluded from Income (lesser of A or D)	$ 250,680
F. Amount Included in Income (A - D)	$ 25,122

Explanation:

Prepared By:

Tax Mam Inc
10413 Torre Ave, Ste 500
Cupertino CA 95014
Tel: (408) 446-4451 Fax: (408) 973-8757

04-20-2010

APPENDIX

Notice 2006-83 Statement

Pending Bankruptcy Case

The taxpayer, _____, filed a bankruptcy petition under chapter 11 of the Bankruptcy Code in the Bankruptcy Court for the District of_____ . The bankruptcy court case number is _____. Gross income, and withheld federal income tax, reported on Form W-2, Forms 1099, Schedule K-1, and other information returns received under the taxpayer's name and social security number (or other taxpayer identification number) are allocated between the taxpayer's TIN and the bankruptcy estate's EIN as follows, using [describe allocation method]:_____.

Year	Taxpayer	Estate
1. Form W-2, Payor: _____	$ _____	$ _____
Withheld income tax shown on Form W-2	$ _____	$ _____
2. Form 1099-INT Payor: _____	$ _____	$ _____
Withheld income tax (if any) shown on Form 1099-INT	$ _____	$ _____
3. Form 1099-DIV Payor: _____	$ _____	$ _____
Withheld income tax (if any) shown on Form 1099-DIV	$ _____	$ _____
4. Form 1099-MISC Payor:_____	$ _____	$ _____
Withheld income tax (if any) shown on Form 1099-MISC	$ _____	$ _____

Income of the Estate in Chapter 7 Cases of Individuals

The gross income of the bankruptcy estate includes any of the debtor's gross income to which the estate is entitled under the Bankruptcy Code. It also includes income generated by the bankruptcy estate, from property in the estate, after the commencement of the case.

Gross income of the estate does not include amounts received or accrued by the debtor before the commencement of the case. Additionally, gross income of the estate in a Chapter 7 case does not include any income that the debtor earns after the bankruptcy petition date.

The Estate Income in Individuals' Chapter 11 Cases

For Chapter 11 individual cases filed before October 17, 2005, gross income of the estate is determined in the same manner as in Chapter 7 cases involving individuals. Notably, gross income of the estate generally does not include any income that the debtor earns after the commencement of the bankruptcy case.

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. section 1115. Under IRC section 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 estate's return in cases filed after October 17, 2005.

If a Chapter 11 case is converted to a Chapter 13 case, the Chapter 13 estate is not a separate taxable entity and earnings from post-conversion services and income from property of the estate realized after the conversion to Chapter 13 are taxed to the debtor. If the Chapter 11 case is converted to a Chapter 7 case, 11 U.S.C. section 1115 does not apply after conversion and:

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

Allocation of income and credits on information returns and required statement for returns for Chapter 11 cases of individuals filed after October 16, 2005

For Chapter 11 cases, if an employer issues a Form W-2 reporting all of the debtor's wages, salary, or other compensation for a calendar year, and a portion of the earnings represent post-petition services includible in the estate's gross income, the Form W-2 amounts must be allocated between the estate and the debtor. The debtor-in-possession or the trustee must allocate the amounts reported in box 1 and the withheld income tax reported in box 2 of Form W-2 between the debtor and the estate. The allocations must

reflect that the debtor's gross earnings from post-petition services and gross income from post-petition property are, generally, includible in the estate's gross income and not the debtor's gross income. The debtor and trustee may use a simple percentage method to allocate income and withheld income tax. The same method must be used to allocate the income and the withheld tax.

If information returns are issued to the debtor for gross income, gross proceeds, or other reportable payments that should have been reported to the bankruptcy estate, the debtor-in-possession or trustee must allocate the improperly reported income in a reasonable manner between the debtor and the estate. In general, the allocation must ensure that any income and income tax withheld attributable to the post-petition period is reported on the estate's return, and any income and income tax withheld attributable to the pre-petition period is reported on the debtor's return.

The debtor must attach a statement to his or her income tax return stating that the return is filed subject to a Chapter 11 bankruptcy case. The statement must also:

- Show the allocations of income and withheld income tax,
- Describe the method used to allocate income and withheld tax, and
- List the filing date of the bankruptcy case, the bankruptcy court in which the case is pending, the bankruptcy court case number, and the bankruptcy estate's EIN.

TAX RETURN FOR THE BANKRUPTCY ESTATE

From IRS Pub 908, Bankruptcy Tax Guide

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts 2008 OMB No. 1545-0092

A Type of entity (see instr.):
- ☐ Decedent's estate
- ☐ Simple trust
- ☐ Complex trust
- ☐ Qualified disability trust
- ☐ ESBT (S portion only)
- ☐ Grantor type trust
- ☑ Bankruptcy estate–Ch. 7
- ☐ Bankruptcy estate–Ch. 11
- ☐ Pooled income fund

For calendar year 2008 or fiscal year beginning , 2008, and ending , 20

Name of estate or trust (If a grantor type trust, see page 14 of the instructions.): Thomas Smith Bankruptcy Estate

C Employer identification number: 00 : 0000000

Name and title of fiduciary: Joan Black, Trustee

D Date entity created: 12-15-2007

Number, street, and room or suite no. (If a P.O. box, see page 15 of the instructions.): 111 State Street

City or town, state, and ZIP code: Anywhere, Anystate, 00000

E Nonexempt charitable and split-interest trusts, check applicable boxes (see page 16 of the instr.):
- ☐ Described in section 4947(a)(1)
- ☐ Not a private foundation
- ☐ Described in section 4947(a)(2)

B Number of Schedules K-1 attached (see instructions) ▶

F Check applicable boxes: ☐ Initial return ☑ Final return ☐ Amended return ☐ Change in fiduciary ☐ Change in fiduciary's name ☐ Change in trust's name ☐ Change in fiduciary's address

G Check here if the estate or filing trust made a section 645 election ▶ ☐

Income	1	Interest income	1	
	2a	Total ordinary dividends	2a	
	b	Qualified dividends allocable to: (1) Beneficiaries (2) Estate or trust		
	3	Business income or (loss). Attach Schedule C or C-EZ (Form 1040)	3	
	4	Capital gain or (loss). Attach Schedule D (Form 1041)	4	
	5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5	
	6	Farm income or (loss). Attach Schedule F (Form 1040)	6	
	7	Ordinary gain or (loss). Attach Form 4797	7	
	8	Other income. List type and amount	8	
	9	**Total income.** Combine lines 1, 2a, and 3 through 8 ▶	9	
Deductions	10	Interest. Check if Form 4952 is attached ▶ ☐	10	
	11	Taxes	11	
	12	Fiduciary fees	12	
	13	Charitable deduction (from Schedule A, line 7)	13	
	14	Attorney, accountant, and return preparer fees	14	
	15a	Other deductions **not** subject to the 2% floor (attach schedule)	15a	
	b	Allowable miscellaneous itemized deductions subject to the 2% floor	15b	
	16	Add lines 10 through 15b ▶	16	
	17	Adjusted total income or (loss). Subtract line 16 from line 9 [17]		
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	
	19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19	
	20	Exemption	20	
	21	Add lines 18 through 20 ▶	21	
Tax and Payments	22	Taxable income. Subtract line 21 from line 17. If a loss, see page 23 of the instructions	22	
	23	**Total tax** (from Schedule G, line 7)	23	2,055
	24	**Payments:** a 2008 estimated tax payments and amount applied from 2007 return	24a	2,400
	b	Estimated tax payments allocated to beneficiaries (from Form 1041-T)	24b	
	c	Subtract line 24b from line 24a	24c	2,400
	d	Tax paid with Form 7004 (see page 24 of the instructions)	24d	
	e	Federal income tax withheld. If any is from Form(s) 1099, check ▶ ☐	24e	
		Other payments: f Form 2439 ; g Form 4136 ; Total ▶	24h	
	25	**Total payments.** Add lines 24c through 24e, and 24h ▶	25	2,400
	26	Estimated tax penalty (see page 24 of the instructions)	26	
	27	**Tax due.** If line 25 is less than the total of lines 23 and 26, enter amount owed	27	
	28	**Overpayment.** If line 25 is larger than the total of lines 23 and 26, enter amount overpaid	28	345
	29	Amount of line 28 to be: **a Credited to 2009 estimated tax ▶** ; **b Refunded ▶**	29	345

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joan Black, Trustee — Signature of fiduciary or officer representing fiduciary
2/15/2007 — Date
▶ 00 : 0000001 — EIN of fiduciary if a financial institution

May the IRS discuss this return with the preparer shown below (see instr.)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11370H Form **1041** (2008)

Attachment to Form 1041—DO NOT DETACH !!

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** **2008** (99) IRS Use Only—Do not write or staple in this space.

OMB No. 1545-0074

Label (See instructions on page 14.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

For the year Jan. 1–Dec. 31, 2008, or other tax year beginning , 2008, ending , 20

Your first name and initial	Last name	Your social security number
Thomas	Smith Bankruptcy Estate	000 : 00 : 0000
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Joan	Black, Trustee	000 : 00 : 0001
Home address (number and street). If you have a P.O. box, see page 14.	Apt. no.	▲ You must enter your SSN(s) above. ▲
111 State Street		
City, town or post office, state, and ZIP code. If you have a foreign address, see page 14.		Checking a box below will not change your tax or refund.
Anywhere, Anystate, 00000		

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 14) ▶ ☐ You ☐ Spouse

Filing Status Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☑ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 15.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 16)

Exemptions

6a ☑ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**

Boxes checked on 6a and 6b: 1
No. of children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 18)

Dependents on 6c not entered above
Add numbers on lines above ▶: 1

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 17)
			☐
			☐
			☐
			☐

If more than four dependents, see page 17.

d Total number of exemptions claimed

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 21.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
8a	**Taxable** interest. Attach Schedule B if required	8a	5,500
b	**Tax-exempt** interest. **Do not** include on line 8a (8b)		
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends (see page 21) (9b)		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	(1,500)
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions (15a) b Taxable amount (see page 23)	15b	
16a	Pensions and annuities (16a) b Taxable amount (see page 24)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	40,000
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits (20a) b Taxable amount (see page 26)	20b	
21	Other income. List type and amount (see page 28)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	44,000

Adjusted Gross Income

23	Educator expenses (see page 28) (23)		
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ (24)		
25	Health savings account deduction. Attach Form 8889 (25)		
26	Moving expenses. Attach Form 3903 (26)		
27	One-half of self-employment tax. Attach Schedule SE (27)		
28	Self-employed SEP, SIMPLE, and qualified plans (28)		
29	Self-employed health insurance deduction (see page 29) (29)		
30	Penalty on early withdrawal of savings (30)		
31a	Alimony paid b Recipient's SSN ▶ (31a)		
32	IRA deduction (see page 30) (32)		
33	Student loan interest deduction (see page 33) (33)		
34	Tuition and fees deduction. Attach Form 8917 (34)		
35	Domestic production activities deduction. Attach Form 8903 (35)		
36	Add lines 23 through 31a and 32 through 35	36	0
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶	37	44,000

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Form 1040 (2008) Page 2

Tax and Credits	38	Amount from line 37 (adjusted gross income)		38	44,000
	39a	Check if: ☐ You were born before January 2, 1944, ☐ Blind. ☐ Spouse was born before January 2, 1944, ☐ Blind. Total boxes checked ▶ 39a			
	b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 34 and check here ▶ 39b ☐			
	c	Check if standard deduction includes real estate taxes or disaster loss (see page 34) ▶ 39c ☐			
Standard Deduction for— • People who checked any box on line 39a, 39b, or 39c or who can be claimed as a dependent, see page 34. • All others: Single or Married filing separately, $5,450 Married filing jointly or Qualifying widow(er), $10,900 Head of household, $8,000	40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)		40	24,120
	41	Subtract line 40 from line 38		41	19,880
	42	If line 38 is over $119,975, or you provided housing to a Midwestern displaced individual, see page 36. Otherwise, multiply $3,500 by the total number of exemptions claimed on line 6d		42	3,500
	43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-		43	16,380
	44	**Tax** (see page 36). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972		44	2,055
	45	**Alternative minimum tax** (see page 39). Attach Form 6251		45	
	46	Add lines 44 and 45 ▶		46	
	47	Foreign tax credit. Attach Form 1116 if required	47		
	48	Credit for child and dependent care expenses. Attach Form 2441	48		
	49	Credit for the elderly or the disabled. Attach Schedule R	49		
	50	Education credits. Attach Form 8863	50		
	51	Retirement savings contributions credit. Attach Form 8880	51		
	52	Child tax credit (see page 42). Attach Form 8901 if required	52		
	53	Credits from Form: a ☐ 8396 b ☐ 8839 c ☐ 5695	53		
	54	Other credits from Form: a ☐ 3800 b ☐ 8801 c ☐	54		
	55	Add lines 47 through 54. These are your **total credits**		55	
	56	Subtract line 55 from line 46. If line 55 is more than line 46, enter -0- ▶		56	2,055
Other Taxes	57	Self-employment tax. Attach Schedule SE		57	
	58	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919		58	
	59	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required		59	
	60	Additional taxes: a ☐ AEIC payments b ☐ Household employment taxes. Attach Schedule H		60	
	61	Add lines 56 through 60. This is your **total tax** ▶		61	2,055
Payments	62	Federal income tax withheld from Forms W-2 and 1099	62		
	63	2008 estimated tax payments and amount applied from 2007 return	63	2,400	
If you have a qualifying child, attach Schedule EIC.	64a	**Earned income credit (EIC)**	64a		
	b	Nontaxable combat pay election 64b			
	65	Excess social security and tier 1 RRTA tax withheld (see page 61)	65		
	66	Additional child tax credit. Attach Form 8812	66		
	67	Amount paid with request for extension to file (see page 61)	67		
	68	Credits from Form: a ☐ 2439 b ☐ 4136 c ☐ 8801 d ☐ 8885	68		
	69	First-time homebuyer credit. Attach Form 5405	69		
	70	Recovery rebate credit (see worksheet on pages 62 and 63)	70		
	71	Add lines 62 through 70. These are your **total payments** ▶		71	2,400
Refund Direct deposit? See page 63 and fill in 73b, 73c, and 73d, or Form 8888.	72	If line 71 is more than line 61, subtract line 61 from line 71. This is the amount you **overpaid**		72	345
	73a	Amount of line 72 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐		73a	345
	▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings			
	▶ d	Account number			
	74	Amount of line 72 you want **applied to your 2009 estimated tax** ▶	74		
Amount You Owe	75	**Amount you owe.** Subtract line 71 from line 61. For details on how to pay, see page 65 ▶		75	
	76	Estimated tax penalty (see page 65)	76		

Third Party Designee Do you want to allow another person to discuss this return with the IRS (see page 66)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here Joint return? See page 15. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
			( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no. ( )	

Form **1040** (2008)

Insolvency Worksheet

Keep for Your Records

Date debt was canceled (mm/dd/yy)		
Part I. Total liabilities immediately before the cancellation (do not include the same liability in more than one category)		
	Liabilities (debts)	**Amount Owed Immediately Before the Cancellation**
1.	Credit card debt	$
2.	Mortgage(s) on real property (including first and second mortgages and home equity loans) (mortgage(s) can be on personal residence, any additional residence, or property held for investment or used in a trade or business)	$
3.	Car and other vehicle loans	$
4.	Medical bills	$
5.	Student loans	$
6.	Accrued or past-due mortgage interest	$
7.	Accrued or past-due real estate taxes	$
8.	Accrued or past-due utilities (water, gas, electric)	$
9.	Accrued or past-due child care costs	$
10.	Federal or state income taxes remaining due (for prior tax years)	$
11.	Loans from 401(k) accounts and other retirement plans	$
12.	Loans against life insurance policies	$
13.	Judgments	$
14.	Business debts (including those owed as a sole proprietor or partner)	$
15.	Margin debt on stocks and other debt to purchase or secured by investment assets other than real property	$
16.	Other liabilities (debts) not included above	$
17.	**Total liabilities immediately before the cancellation. Add lines 1 through 16.**	$
Part II. Fair market value (FMV) of assets owned immediately before the cancellation (do not include the FMV of the same asset in more than one category)		
	Assets	**FMV Immediately Before the Cancellation**
18.	Cash and bank account balances	$
19.	Residences (including the value of land) (can be personal residence, any additional residence, or property held for investment or used in a trade or business)	$
20.	Cars and other vehicles	$
21.	Computers	$
22.	Household goods and furnishings (for example, appliances, electronics, furniture, etc.)	$
23.	Tools	$
24.	Jewelry	$
25.	Clothing	$
26.	Books	$
27.	Stocks and bonds	$
28.	Investments in coins, stamps, paintings, or other collectibles	$
29.	Firearms, sports, photographic, and other hobby equipment	$
30.	Interest in retirement accounts (IRA accounts, 401(k) accounts, and other retirement accounts)	$
31.	Interest in a pension plan	$
32.	Interest in education accounts	$
33.	Cash value of life insurance	$
34.	Security deposits with landlords, utilities, and others	$
35.	Interests in partnerships	$
36.	Value of investment in a business	$
37.	Other investments (for example, annuity contracts, guaranteed investment contracts, mutual funds, commodity accounts, interest in hedge funds, and options)	$
38.	Other assets not included above	$
39.	**FMV of total assets immediately before the cancellation. Add lines 18 through 38.**	$
Part III. Insolvency		
40.	**Amount of insolvency.** Subtract line 39 from line 17. If zero or less, you are not insolvent.	$

FORM 982

Form **982**
(Rev. March 2009)
Department of the Treasury
Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

► Attach this form to your income tax return.

OMB No. 1545-0046
Attachment Sequence No. **94**

Name shown on return | Identifying number

Part I **General Information** (see instructions)

1 Amount excluded is due to (check applicable box(es)):
- a Discharge of indebtedness in a title 11 case ☐
- b Discharge of indebtedness to the extent insolvent (not in a title 11 case) ☐
- c Discharge of qualified farm indebtedness ☐
- d Discharge of qualified real property business indebtedness ☐
- e Discharge of qualified principal residence indebtedness ☐
- f Discharge of certain indebtedness of a qualified individual because of Midwestern disasters ☐

2 Total amount of discharged indebtedness excluded from gross income. 2

3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? ☐ Yes ☐ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	4
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8
9	Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge	9
10a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness.*	10a
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked*	10b
11	For a discharge of qualified farm indebtedness, applied to reduce the basis of:	
a	Depreciable property used or held for use in a trade or business, or for the production of income, if not reduced on line 5	11a
b	Land used or held for use in a trade or business of farming	11b
c	Other property used or held for use in a trade or business, or for the production of income	11c
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13

Part III **Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)**

Under section 1081(b), the corporation named above has excluded $ _____ from its gross income for the tax year beginning _____, and ending _____.
Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of _____.
(State of incorporation)

Note. *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

For Paperwork Reduction Act Notice, see page 5 of this form. Cat. No. 17066E Form **982** (Rev. 3-2009)

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REPRESENTATION BEFORE THE COLLECTION DIVISION OF THE IRS

By Robert E. McKenzie

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