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Questions and answers on the tax implications of personal bankruptcy

The Tax Consequences to Individuals Who File Bankruptcy

By Ray A. Knight and Lee G. Knight

A person entering bankruptcy has a number of decisions to make affecting his or her taxes. An understanding of the Federal tax consequences of bankruptcy is critical to making the right decision.

We hear the word "bankruptcy" more and more. In 1990, 714,683 individuals filed for bankruptcy due to depressed economic situations and other conditions. The number of bankruptcies continues to increase across the nation, up 17% in 1990 from 1989.

Bankruptcy Proceedings

Bankruptcy proceedings are started by filing a petition in a bankruptcy court. To receive the greatest tax advantage, a taxpayer should be aware of the timing of filing for bankruptcy. Either a debtor or group of creditors (meeting certain qualifications) may file the petition. The date on which the petition is filed is called the "commencement date." Whether the petition is filed by the debtor (voluntary bankruptcy) or a group of creditors (involuntary bankruptcy), an "order for relief" (discharge of debt) is what's being requested of the bankruptcy court.

Though several types of bankruptcies exist, the following types will be the main emphasis of this discussion:

- Chapter 7—Liquidation
- Chapter 11—Reorganization
- Chapter 12—Family Farmer With Regular Income—Adjustment
- Chapter 13—Individual With Regular Income—Adjustment

Each of the four types of bankruptcies is available to individuals.

The Estate. An estate is a separate taxable entity. Under Chapter 7 or 11, an estate is created on the commencement date of bankruptcy. Under Chapter 12 or 13, no separate taxable entity is created. Normally, all legal interests in property of the debtor on the commencement date are included in the "estate." However, certain properties are exempt from the estate. These properties are defined by two different authorities: 1) the Bankruptcy Code and 2) other Federal, state, and local law. A debtor has the choice of selecting the authority by which to exempt property from the estate.

Termination of Taxable Year. Under Chapter 7 or 11, the debtor is permitted to terminate his/her taxable year, as of the day before the commencement date. If no election is made, the debtor's taxable year is uninterrupted by the bankruptcy.

Example. A taxpayer is a calendar year taxpayer. He filed bankruptcy on April 2, 1992. Option 1: First tax year—1/1/92 to 4/1/92; second tax year—4/2/92 to 12/31/92. Option 2: Regular tax year—1/1/92 to 12/31/92.

Transfer of Tax Attributes. The Bankruptcy Tax Act of 1980 (The Act) allows a debtor and an estate to be separate taxable entities. Certain tax attributes of the individual debtor are allowed to transfer to the estate. These tax attributes are determined as of the first day of the debtor's taxable year in which the bankruptcy case starts. The following are the tax attributes that transfer from debtor to estate:

1. Net operating loss (NOL) carryover;
2. Carryover of excess charitable contributions;
3. Any amount to which recovery of tax benefit items apply;
4. Carryovers of any credit, and all other items which (if not for the commencement of the bankruptcy) would be required to be taken by the debtor;
5. Capital loss carryover;
6. The basis, holding period, and character of an asset on the debtor's books (except by sale or exchange);
7. Method of accounting used by the debtor;
8. Other tax attributes of debtor.

The IRS has recently issued proposed regulations that provide that in Chapter 7 or 11 bankruptcies, the estate will also succeed to the passive activity losses and credits of individual debtors which are disallowed under Sec. 469, as well as losses of such debtors disallowed under IRC Sec. 465 because the taxpayer is not "at risk" with respect to the activity. Such disallowed losses and credits are treated as a deduction allocable to the same activity in the next taxable year. The provisions of the proposed regulations are effective for bankruptcy cases commencing on or after November 9, 1992. For cases begun before that date, the proposed regulations will apply only if a joint election is made by the debtor and estate. In a Chapter 7 case, the election requires the written consent of the bankruptcy trustee, and in a Chapter 11 case it must be incorporated into a bankruptcy plan that is confirmed by the bankruptcy court or into an order of the court.

As a result of the transfer of tax at-

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tributes to the estate, the debtor is denied the right to use these tax attributes as of the commencement date of the case. However, upon termination of the estate, the tax attributes of the estate are transferred back to the debtor. The debtor also receives the tax attributes that arose while the case was pending such as net operating losses or capital losses of the estate. In determining the number of years for which a carryover can be used, the debtor should also count the taxable years of the estate. Also, any net operating losses acquired should be considered.

Carrybacks. The estate is allowed to use such transferred loss carryforwards and tax credits against pre-bankruptcy tax years of the debtor. If the carryback results in a refund, the refund is the property of the estate; the bankrupt individual gave up the right to this refund when filing for bankruptcy.

Allocation of Income. Gross income of the estate for each taxable year includes the gross income of the debtor excluding any amounts received or accrued by the debtor before the commencement date. Tax accounting principles which apply in determining the timing of the receipt of income also apply in determining whether income is to be taxed to the estate or the debtor. Therefore, an item accrued before bankruptcy by an accrual basis taxpayer is taxed to the debtor. On the other hand, for a cash basis taxpayer, income is taxed based on whether the debtor or the estate receive it. Normally, income of a cash basis debtor paid to the estate is taxed to the estate. However, "constructive receipt" rules should be followed.

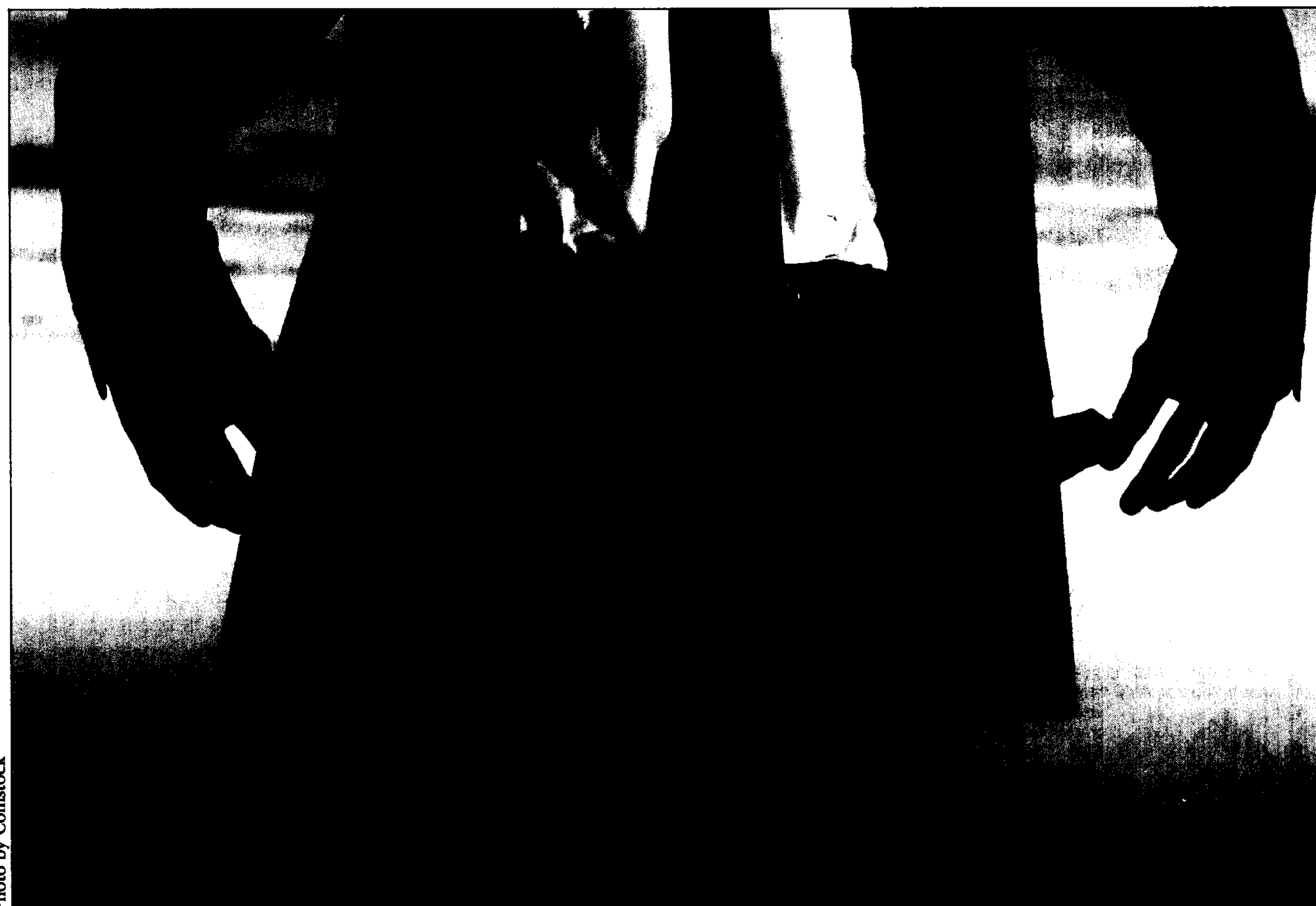
Example. If a wage payment is earned before bankruptcy but paid to the estate after bankruptcy, application of the "constructive receipt" rules would result in the wage being included in debtor's income. Where an amount of income is taxable to the debtor, it is not taxable to the estate, and vice versa.

Allocation of Expense. Tax accounting principles which determine the period in which expenses are deductible also apply in determining whether an expense is deductible by the estate or the debtor.

Therefore, an accrual basis debtor would be entitled to deduct an expense accrued before bankruptcy, even if it was paid by the estate. Where an expense is allowable as a deduction to a debtor, it is not allowed to be included as a deduction for the estate, and vice versa. Application of the same tax accounting principles on both income and expense prevents distortion, allowing an accrual basis debtor the right to an accrued deduction if he/she at the same time is forced to recognize accrual income.

Tax Treatment of Debtor

Tax Liabilities. Caution must be used in determining whether tax liabilities are a liability of the estate or debtor. The rule is that if bankruptcy occurs during an individual's taxable year, tax liabilities for the preceding taxable year, which has closed, will be liabilities of the estate, while tax liabilities for the taxable year in which the bankruptcy takes place (assuming the year does not end until



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after the commencement date) will not be liabilities of the estate.

Tax Return. As stated previously, a debtor normally has the election to terminate his/her taxable year, with the new taxable year starting on the commencement date of his/her bankruptcy. This election must be made on or before the due date for filing the return for the taxable year ending on the commencement date. Generally, returns must be filed on, or before, the fifteenth day of the fourth month following the day before the bankruptcy case begins.

To make this election to close the taxable year on the day before the commencement date, a debtor either: 1) files a timely return for the short year ending the day before the commencement date, filing on or before the due date of the return, or 2) attaches a statement of election to an application for an extension of time for filing the return and files the application on or before the due date of the return. If the individual is married, his or her spouse may also join in the election, if the debtor and spouse file a joint return for the short taxable year ending on the day before the commencement date of the bankruptcy.

A bankrupt individual who elects a short taxable year must annualize income. To annualize income, the income for the short taxable year is multiplied by twelve (12) and the result is divided by the number of months in the short taxable year. The debtor applies the tax rate appropriate for the tax bracket in which the annualized income falls.

Normally, it is to the advantage of the bankrupt individual to elect a short taxable year because the tax liability for the short year would then be a claim against the estate. Consequently, there is an opportunity for the property of the estate to satisfy the tax claim and allow the debtor no personal liability for the tax. If the estate property is not sufficient to cover this tax claim, this tax claim is dischargeable in bankruptcy and would not become a liability of the debtor.

If the bankrupt individual has excess deductions, net operating losses, or unused credits for the taxable year during which bankruptcy proceedings are started, it will not be to the debtor's advantage to elect the short taxable year, where these benefits would pass to the estate. Non-election would place the deductions, losses, and credits in the unbroken taxable year of the debtor thereby making these tax attributes available to reduce the tax liability for this taxable year. And since the debtor cannot carryback post-bankruptcy net operating losses or post-bankruptcy unused tax credits to pre-bankruptcy years, any net operating losses or unused tax credits for the unbroken year can be carried forward by the debtor to reduce tax liabilities in later years.

Transfer of Property. Upon the commencement date of bankruptcy, assets are transferred from the bankrupt individual to the estate. Such a transfer (other than by sale or exchange) is not considered to be a disposition of the property and does not lead to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions. Similarly, when the bankruptcy case is ended, and the assets (if any) are transferred back to the debtor, this transfer is also not considered to be a disposition of the property.

Debt Discharge. In a bankruptcy, the discharge of the debtor's debts does not affect the income and deductions of the individual debtor because the discharge of indebtedness is excluded from the gross income of the debtor. However, there is an indirect effect on the debtor as a result of such debt discharge.

When debt is discharged in a bankruptcy, in order for the estate to be eligible to exclude the debt-discharge amount from gross income, the estate must either reduce its tax attributes such as net operating losses or reduce the basis of depreciable property of the estate. Reduction of tax attributes is made on a dollar-for-dollar basis, except the reduction of credit carryovers is computed as one-dollar-for-three dollars of debt discharge. The choice of whether to reduce tax attributes or the basis of depreciable property is at the election of the debtor. When tax attributes such as net operating losses are reduced, future tax benefits are reduced. When depreciable property basis is reduced, subsequent disposition of the property creates ordinary income to the extent of the lesser of the earlier basis reduction or the amount of gain realized on the subsequent sale.

With either the tax attributes reduction or the depreciable property basis reduction, the estate decreases the future tax advantages of the estate assets. When the bankruptcy proceeding ends and the assets (if any) are transferred

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back to the debtor, the debtor becomes the holder of assets with decreased future tax advantages.

Tax Treatment of Estate

Gross Income. The gross income of the estate includes any income generated by the estate. Gross income also includes income of the debtor paid to the estate which was not received or accrued by the debtor before the commencement date of the bankruptcy. The amount included in gross income for any gain or loss from the sale of an asset of the estate is dependent upon the basis, character, and holding period the asset had in the debtor's hands. The gross income of the estate does not include any debt-discharge income, if a counter-balancing reduction was made in either tax attributes or depreciable property basis.

Deductions. The deductions of the bankrupt estate include expenses incurred by the estate, and expenses of the debtor paid by the estate to the extent such expenses are not accrued by an accrual basis debtor before the commencement date of the bankruptcy. Deductions and credits of the estate also include the tax attributes that are transferred to the estate from the debtor. Whether any amount paid or incurred by the estate is allowable as a deduction or credit, or is wages, is determined as if the amount were paid or incurred by the debtor, and as if the debtor were still engaged in trades, businesses, and activities the debtor was engaged in before the bankruptcy proceedings started.

Example. George Roberts, a cash-basis taxpayer operates a sole proprietorship and files a petition of bankruptcy on June 1, 1992. Roberts' business ceases to operate when Roberts declares bankruptcy. At the time of bankruptcy, Roberts has unpaid business expenses of $40,000, $10,000 of which the trustee pays. The $10,000 that is paid by the trustee is an allowable deduction for the estate as a trade or business expense even though the estate never conducts a trade or business. These expenses will become part of the net-operating-loss deduction, which will be carried back to apply to the debtor's earlier taxable years.

The administrative expenses of the estate are also allowable as deductions. Administrative expenses do not have to meet the qualifications of trade or business expenses or expenses for the production of income but can only be deducted if allowed by a specific provision of the IRC.

Example. Federal income taxes are classified as administrative expenses. But under the IRC, no specific provision allows for the deduction of Federal income taxes. Therefore, even though Federal income taxes are administrative expenses, they are not allowed as deductions of the estate.

Other administrative expenses which can not be deducted are capital expenditures (which qualify for capitalization) and expenses related to tax-exempt interest.

The estate is also allowed to carryback and carryover administrative expenses. This permits a deduction, which would not otherwise be allowed, since administrative expenses can exceed business income or they may not be qualified trade or business expenses. Therefore, these administrative expenses receive special treatment in that they are allowed carryback or carryover.

The net-operating-loss calculation for the taxable year must be made before

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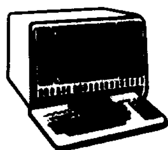

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the calculation of the administrative expense losses. In other words, net operating loss carrybacks and carryovers must be applied against income of the estate before any administrative expense loss carrybacks or carryovers. However, administrative expense losses (unlike net operating losses) can not be carried back to taxable years of the debtor ending before the commencement date, and neither can any administrative losses be transferred back to the debtor at the close of bankruptcy.

Example. Linda Robinson starts bankruptcy proceedings on June 1, 1991, and does not elect to close her taxable year when bankruptcy begins. For tax years 1989 and 1990, Robinson had total taxable income of $32,000. For the tax year June 1, 1991 to May 31, 1992, the estate had $10,000 of taxable income. For the tax year June 1, 1992 to May 31, 1993, the estate has a NOL of $40,000 and a administrative expense loss of $12,000.

The $40,000 NOL can be carried back to Robinson's 1989 and 1990 tax years, reducing the NOL to $8,000. No carryback of the administrative loss is allowable. For the tax year June 1, 1991, to May 31, 1992, the remaining $8,000 of NOL carryback is applied to the $10,000, eliminating the NOL carryback and reducing the estate's income to $2,000 for this period. This $2,000 would then be eliminated by the administrative loss carryback. At the close of the estate on June 1, 1993, the unused $10,000 administrative loss would not transfer to the debtor.

Taxable Income. The estate's taxable income is calculated in the same manner as it would have been for the individual debtor. The estate's tax is calculated and paid by the estate. Under bankruptcy, the estate must use the tax rates that apply to a married individual filing separately. An estate that does not itemize uses the standard deduction of a married individual filing separately.

Accounting Method. As noted previously, the accounting method of the individual is transferred to the estate and therefore the estate uses the same method. However, the estate is not required to use the debtor's taxable year. The estate can change the annual accounting period one time without the approval of the Secretary of the Treasury. This is done to permit the closing of the estate's taxable year before the termination of the estate so the estate can request an expedited determination of its tax liability.

Returns. Under Chapter 7 or 11, a return is required to be filed for the estate if the income of the estate is equal to or greater than the sum of the exemption amount plus the standard deduction for a married individual filing separately. The return should be filed on Form 1041. If a bankruptcy case has been dismissed, the estate is not required to file a return. In addition, if both the estate and the debtor have filed returns and the bankruptcy case is subsequently dismissed, the debtor would have to file an amended return to include income and deductions reported by the estate, and the estate's return would become void and have no effect.

Tax Decisions

Bankruptcy as a whole is a very complicated procedure. Much thought should be given to the timing of the bankruptcy as well as the type of bankruptcy an individual debtor chooses. Other tax decisions facing the debtor are:

- Whether to terminate the taxable year on the day before the commencement date of the bankruptcy.
- Whether to sell assets before or after declaration of bankruptcy. Gains incurred after bankruptcy become the estate's gains and can be offset by estate losses. Gains incurred before bankruptcy become the debtor's gains and can be offset by debtor's losses. Consideration should also be given to the estate's ability to carryback.
- Whether to offset debt discharge by reduction of depreciable property basis of the estate or reduction of the tax attributes of the estate.

The decisions that are made affect the tax advantages of bankruptcy. Of course, another tax advantage is the discharge of certain tax liabilities.

Bankruptcy discharges most past debts of the debtor and gives the debtor a fresh start from his/her financially distressed situation. Legalistically, after a debtor has chosen bankruptcy, in the eyes of the business world the debtor is forgiven and can not be discriminated against because of his/her bankruptcy. ❑

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