



## **INCOME TAX CONSEQUENCES OF COMMON COMMERCIAL BANKRUPTCY TRANSACTIONS**

### **FEDERAL INCOME TAX CONSIDERATIONS IN BANKRUPTCY**

Presented By: *Elisa M. Sartori, CPA, Senior VP*  
*Mesirow Financial Consulting LLC*

### **CANCELLATION OF INDEBTEDNESS INCOME AND BANKRUPTCY**

Presented By: *Steven M. Notinger*  
*Donchess & Notinger, P.C.*

### **NET OPERATING LOSSES (NOL's)**

Presented By: *Keith D. Lowey, CPA, President*  
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### **NEGATIVE TAX CONSEQUENCES REALIZED BY EQUITY HOLDERS IN PASS THROUGH ENTITIES**

Presented By: *Richard P. Finkel, CPA, CFE, CIRA*  
*Blum, Shapiro & Co., P.C.*

### **JUDICIAL PERSPECTIVES / CONSIDERATIONS**

Presented By: *Honorable Robert E. Gerber*  
*United States Bankruptcy Court, Southern District of New York*

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#### General Overview: Individuals- Chapters 7 & 11

- Individuals often have to pay taxes when they can least afford to. A little planning and follow through can mean all the difference to them.
- A new taxpaying entity is created at the commencement date of a Title 11 proceeding under chapters 7 & 11
- Tax attributes go to the new entity as of the end of the previous tax year unless
  - Debtor makes an election to create a short year up to the date of the bankruptcy filing
    - Example: Debtor has \$50,000 capital loss carryforward as of 12/23/2006. Files bankruptcy on 5/1/2007 & capital gains of \$25,000 as of that date. Unless he makes this election, he may not offset the capital gains with the loss carryforward, the *bankruptcy estate gets it all*

#### General Overview: Individuals – Chapters 12 & 13

- No new entity is created
- It is presumed the trustee is not responsible for filing tax returns
- The debtor is required to file form 1040 tax returns as usual
- Must work with trustee to obtain information necessary to report all income and deductions
  - Interest income
  - Expenses of the proceeding may be deductible
  - Cash basis taxpayers may be able to deduct distributions to creditors – property & state income taxes, etc.

#### General Overview: C Corporations

- No new entity is created at bankruptcy
- Shareholders generally remain unchanged
- LLC's are usually partnerships for tax purposes, not corporations

#### General Overview: Partnerships

- No new entity is created
- Partners are still partners, (unless some other event occurs which may change this), and will receive flow through income & losses throughout the administration of the estate
- COD Income exclusion determined at partner level – bankruptcy & insolvency exceptions don't apply to the partnership itself
- 11 USC 505(b) relief is not available for any flow through entity

#### General Overview: S Corporations

- No new entity is created
- Shareholders remain, (unless some other event occurs which may change this), and will receive flow through income & losses throughout the administration of the estate
- COD income may be excluded at the corporate level under sec. 108
- A bankruptcy filing alone does not terminate the S Corporation election
- 11 USC 505(b) relief is not available for any flow through entity

#### Tax Attributes: Individuals – Chapters 7 & 11

- Common tax attributes individuals send to the bankruptcy estate
  - Net operating losses
  - Capital loss carryforwards
  - Tax credits
  - Charitable contribution carryforwards
  - Basis, holding period & character of assets received by the estate from the Debtor
  - Method of accounting
  - Unused passive activity losses & credits
  - Unused losses from at-risk activities
  - Exclusion from income the gain on sale of personal residence (after 12/24/2002)
- Upon termination of the estate the debtor succeeds to the remaining tax attributes (but not the method of accounting)

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#### **Tax Attributes: Individuals – Chapters 12 & 13**

- Because no new taxable entity, tax attributes remain available for individuals in chapters 12 & 13

#### **Tax Attributes: Partnerships, LLC's, Corporations & S Corporations**

- Character, basis & holding period of assets, built in gains, etc. all remain unchanged at filing

#### **Post Confirmation Entities: No New Entity**

- Distributions are done via Debtor's entity
- Can use a Disbursing Agent
- Income from the funds reported by Debtor
- Expenses deducted (if possible) by Debtor
- Gain/Loss on disposition of assets to pay creditors reported by Debtor

#### **Post Confirmation Entities: Liquidating Trusts – Grantor Trust Status**

- Advantages
  - Creditors report net income – preserves assets distributed
  - Creditors often prefer – removes control from debtor to a trustee
- Disadvantages
  - Trustee must obtain federal taxpayer identification numbers from all beneficiaries
    - foreign creditors
  - Tax compliance
  - Disputed claims
    - Often put in separate, non grantor sub trust (could be additional compliance requirements)
  - Restrictions on investment options
- Annual Tax Returns are required
- Form 1041 with Grantor Tax Information Letters attached
- Creditors are allocated income and loss based on % of total claims
  - Can be tricky
    - Claims expunged in a later year
    - Disputed claims
- To qualify for grantor trust status, plan, disclosure statement & trust document should comply with Rev. Proc. 94-45:
  - Trust organized for primary purpose of liquidating the assets transferred to it
  - Transfer of assets – debtor treat transfer of assets as first to creditors, then the creditors transfer the assets to the trust. Trust document must provide for how any tax due from the transfer will be paid by the debtor
  - Beneficiaries of the trust must be treated as grantors and deemed owners of the trust
  - Plan, disclosure statement & trust document must provide for consistent valuations of the transferred property
- Trustee must file tax returns for the trust as a grantor trust pursuant to Reg. 1.671-4(a)
- If there are disputed claims, a reserve should be established
- Plan or trust instrument should provide for current taxation of all trust earnings (including provision for how the tax on income allocated to disputed claims will be paid)
- Trust instrument should contain a fixed or determinable termination date – extensions are allowed for finite periods only with court approval
- If the trust is to receive assets of an ongoing business, partnership interests, or 50% or more of the stock of a corporation or listed stocks or securities, there should be a good explanation as to the necessity for them available.
- Trust cannot receive or retain cash or cash equivalents in excess of what is necessary to meet claims and maintain the value of the assets during liquidation
- Investment powers of the trustee should be limited to those reasonably necessary to maintain the value of the assets & should be invested in demand and time deposits, such as short-term certificates of deposit, in banks or other savings institutions, or other temporary, liquid investments (i.e. T bills)
- Trust should be required to distribute to beneficiaries at least annually, the net proceeds from the sale of assets (net of amounts necessary to maintain value & meet claims or contingent liabilities)
- Trustee should be required to make continuing efforts to dispose of trust assets, make timely distributions, & to not unduly prolong the duration of the trust

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#### **Post Confirmation Entities: Liquidating Trusts – Non Grantor Trust Status**

- Non Grantor Trust Status
- Taxed as corporations
- Advantages
  - Easier tax return preparation
  - Don't need all creditors' tax identification #'s,
  - Less communication with creditors
  - Less restrictions on investment alternatives
  - May be able to obtain section 505(b) prompt determination
- Disadvantages
  - Entity pays tax at corporate level
  - Distributions of net income previously taxed are subject to double taxation as dividends
- To obtain non grantor trust status, plan, disclosure statement & trust documents should expressly state intended tax treatment of entity and purposely fail the requirements of Rev. Proc. 94-45

#### **Post Confirmation Entities: Disputed Ownership Funds**

- Treasury Regulations section 1.468B-9 (February 7, 2006)
- Treated as a corporation and not a grantor trust for tax purposes
- Gain on transfer of assets are taxable to debtor
- Trustee is responsible for filing tax returns
- Requirements
- An escrow account, trust or fund that –
  - Is established to hold money or property subject to conflicting claims of ownership,
  - is subject to the continuing jurisdiction of a court,
  - requires the approval of the court to pay or distribute money or property to, or on behalf of, a claimant, transferor, or transferor-claimant, and
  - is not a qualified settlement fund under sec. 1.468B-1, a bankruptcy estate..., or a liquidating trust under sec 301.7701-4(d).
- Advantages
  - In general, the initial basis of property transferred by, or on behalf of, a transferor is the fair market value of the property at the date of transfer, unless –
    - The transferor is a transferor-claimant, then the fund's initial basis is the same as the transferor's basis at the time of the transfer
    - This can be beneficial when the fair market value of the assets are not readily ascertainable at the time of transfer and the basis in the assets are high
      - Transferor-claimant is: a transferor that claims an ownership interest in the disputed property immediately before and after the transfer
      - May be able to use these rules to tax the income allocated to disputed claimants of a grantor type liquidating trust as a C corporation
      - Generally, transfers to the fund are not taxable to the fund
      - Unused carryovers (net operating losses, capital losses, tax credits, etc.) succeed to the claimants after the termination of the fund in proportion to the value of the assets distributable to each claimant.
- Disadvantages
  - Distributions of after tax income are treated as dividends (double taxation)
  - There is little additional benefit for these funds beyond those received by intentionally failing the grantor trust requirements of a regular liquidating trust, unless the transferor is a claimant as well and the basis in the property is high and the value is in question (i.e. causes of action, closely held stock)
  - The regulations are relatively new and have not been widely used or tested

## INCOME TAX CONSEQUENCES OF COMMON COMMERCIAL BANKRUPTCY TRANSACTIONS

### CANCELLATION OF INDEBTEDNESS INCOME AND BANKRUPTCY

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The concept of cancellation of indebtedness income (hereafter referred to as “COD” income) is simple--if the taxpayer borrows money or property and the taxpayer does not pay it back in full, the savings the taxpayer realizes is taxable income to the taxpayer. ***Going into debt may create wealth according to the Internal Revenue Code.*** The problem of course occurs when the debt is discharged, the taxpayer has already spent or lost the money borrowed--therefore no funds are available from the transaction to pay the COD income arising as a result of the failure to repay the borrowed funds.

#### BACKGROUND

The concept became controlling law in a Supreme Court in a case called U.S. v. Kirby Lumber, 284 U.S. 1 (1931). In this case a taxpayer issued bonds at 18% interest, and the value of the bonds declined substantially. The taxpayer re-purchased its bonds at a discount. The Supreme Court held that the taxpayer had realized an accession to income or wealth in the amount of the difference between the issue price of the bonds and the re-purchase price. This rule was subsequently applied to exchanges of debt for property in addition to exchanges of debt for debt. See Helvering v. American Chicle Co. 291 U.S. 426(1933).

#### STATUTORY FRAMEWORK

Kirby Lumber and the cases that follow it were codified in 26 U.S.C. §108 of the Internal Revenue Code (the “Code”), which was adopted in the Bankruptcy Tax Act of 1980. The code specifically includes as an item of income “income from the cancellation of indebtedness”. See 26 U.S.C. §61(a) (12). The general rule is if the taxpayer is solvent, the taxpayer will have to recognize COD income in the year it is realized. There are both statutory exceptions to the rule and transactions which do not create COD income, which are discussed below.

If there is no exception or deferral, COD income must be realized and the resulting taxes paid in the year it occurs. If COD is realized while the taxpayer is in bankruptcy or insolvent outside of bankruptcy the taxpayer can avoid the immediate realization of COD income in the year it occurs or perhaps avoid it entirely. Also if the taxpayer is solvent and has “qualified real property indebtedness”, “qualified farm indebtedness” or certain student loan forgiveness, the taxpayer can defer and perhaps eliminate COD income as well. See § 108(a) (1) (D) (qualified real property indebtedness—generally limited to acquisition indebtedness—the provision is elective); §108(g) (2) (qualified farm indebtedness); §108(g) (student loans). Also by act of Congress if COD income occurred as a result of a 9/11 death it can be eliminated.

There are planning opportunities, but the bankruptcy code and §108 of the tax code do not mesh together clearly, creating much uncertainty and disagreement among practitioners, particularly with regard to when COD income is recognized in a bankruptcy case, and how it is dealt with in the context of pass through entities.

#### WHAT IS AND IS NOT CANCELLATION OF INDEBTEDNESS INCOME

In addition to the items specifically excluded from COD income by statute mentioned above, the following situations do not create COD income:

**Purchase Money Debt Exception for Solvent Taxpayers.** If the transaction involves the adjustment of the purchase price for solvent taxpayers, then it is not COD income. It is basically limited to situations where the original buyer and seller renegotiate their original agreement. The exception does not apply to third party debts, or situations where the purchase price is reduced because of external factors like the running of the statute of limitations or enforcement problems. See 26 U.S.C. §108(e) (5) (purchase money debt deduction for solvent debtor).

**If COD Also Leads to Deduction:** COD income does not occur if the income is offset by a deduction or expense that result in a tax deduction. See §108(e) (2). The idea is that for a cash basis taxpayer who is discharged from deductible interest expense on a note will not realize any COD income because the COD income would be offset by the deduction the taxpayer would get for the interest expenses. There is no net income. This rule will not help an accrual basis taxpayer, assuming the accrual basis taxpayer already accrued the interest expense so there is nothing to currently deduct or offset against the COD income. This exception would also apply to compromises reached with suppliers, who generate business deductions, but again only if the taxpayer is not an accrual basis taxpayer who has already deducted the expenses. This exception does not apply to reductions in principal. The income must generate a deductible expense.

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Further, if the taxpayer is an accrual basis taxpayer COD income will result if an expense is accrued in a prior year generating NOLs, then the expense is forgiven in a subsequent year if the NOL has not expired. See 26 U.S.C. §111(c). NOLs can be carried forward 20 years.

**Sale or Exchange of Property** COD income is not recognized on a sale or exchange of property except as follows: first the taxpayer needs to determine whether the debt is recourse or non-recourse. If it is recourse then the taxpayer needs to analyze the transaction in two steps—the difference between the fmv and the basis is gain, the difference between the debt and the fmv is COD income. Regs §1.1001-2(c). So the only deferral possibly available to the taxpayer is the COD portion of the income, which is the amount discharged above the fair market value up to the amount of the debt. Remember if the taxpayer is a cash basis taxpayer the amount of the debt will likely be the principal and not include interest since the interest is deductible. §108(e) (2).

If the debt is non-recourse, the Supreme Court has held in Commr. V. Tufts, 461 U.S. 300 (1983) that the difference between the debt and the basis is all gain. There is no COD income and the fmv of the property is irrelevant. If there is no sale or transfer of non-recourse debt and it is simply settled at a discount the Tax Court has held that such a transaction results in COD income. Gershkowitz v. Commr., 88 T.C. 984 (1987); §108(d) (1).

**Is this True In Bankruptcy?** 11 U.S.C. §506(a) may affect this analysis because under the bankruptcy code the claims may be bifurcated into secured and unsecured based upon the value of the property and non-recourse debt may be considered recourse debt as provided in §1111(b).

**Can COD ever be excluded from income as a gift?** It is unlikely that in the commercial context COD income could ever be excluded from income under 26 U.S.C. §102 as a gift. See Comm v. Jacobson, 336 U.S. 28 (1949) court denied gift exclusion noting that in the commercial context there was “at least” the presumption against a gift. Such an exclusion is unlikely, but it is not expressly prohibited by §108 and perhaps in the case of Hurricane Katrina victims (as with the statutory exception for 9/11 victims) such a holding is again possible. It does require the creditor giving something for nothing and intending to do so.

**Contingent and Worthless Obligations.** Since contingent obligations do not initially give rise to an “increase in wealth” their discharge does not give rise to COD income. Hunt v Comr., T.C. Memo 1989-660 (release from contingent liability is not a contribution to a partnership) and Whitmer v. Comr., T.C. Memo 1996-83 (release from a guaranty does not give rise to COD income). Essentially the original transaction has to result in an increase in the Debtor’s assets or there is no COD income when the “obligation” is extinguished. This issue really goes to what was the purchase price of the original debt.

**Disputed Debts.** Debts that are *legitimately* disputed and settled at a discount do not give rise to COD income. See Rood v. Commr 80 AFTR2d ¶ 97-5239 (11<sup>th</sup> Cir 1997) (there must be a genuine dispute as to the enforceability or the amount of the debt).

**Watch out for debt owed by the Debtor that is acquired by related parties at a discount from creditors. Generally, these transactions will be viewed as an acquisition by the Debtor not the related party, and COD income will be recognized by the Debtor. See §108(e) (4) (for rules on the acquisition of indebtedness by related parties.)**

### HOW THE EXCLUSION WORKS IN BANKRUPTCY

Section 108 and the regulations accompanying it provide the statutory framework for the exclusion of COD income in a bankruptcy case. The exclusion is mandatory assuming that the discharge occurs in a “title 11 case.” See 26 U.S.C. §108(a) (1) (a). “A ‘title 11 case’ means a case under title 11 ..., but only if the taxpayer is under the jurisdiction of the court in such a case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the Court.” This may be an issue for liquidating corporations as described more fully below.

Exclusion may also occur if the taxpayer is insolvent but deferral is allowed only up to the amount of the insolvency. See §108(b) (2), (3). Since the insolvency exception doesn’t occur through a definable bankruptcy event like confirmation of a plan, a determination outside of bankruptcy needs to consider when the debt is discharged. This is really a facts and circumstances test unless it is clear the debt can never be collected. See eg. Alpert v. U.S., 430 F. Supp.2d 682 (N.D. Ohio 2006)(court could not find identifying event triggering COD recognition. The evidence was limited to taxpayer’s assertion that creditors “wrote off debt”).

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Assuming COD income otherwise exists, a Debtor in bankruptcy does not have to recognize the income tax, but rather is required to defer it to future years by reducing tax attributes to the extent it has any.

Tax attributes include NOLs or basis or tax credits or similar items that will reduce the Debtor's tax liability in future years. By reducing tax attributes to the extent of COD income the trade off is that the debtor does not have to realize COD income tax liability in a year that it was also in bankruptcy, but it will recognize such income in future years. The concept is deferral not forgiveness.

The Debtor has a limited choice under section §108, it can choose to reduce attributes in the order contained in the order of §108(b) (2) or it can elect to reduce the basis in depreciable property first. See §108(b) (5). Section 108(b) (2) requires attributes to be reduced in the following order:

- NOL- first in the year of COD discharge, then any carryover
- General Business Credits
- Minimum Tax Credit
- Capital Loss Carryovers
- Basis Reduction—limited to the aggregate bases of the property held by the taxpayer immediately after the discharge less the aggregate liabilities of the taxpayer immediately after the discharge. See §1017(b) (2)—this limitation does not apply to depreciable property reduction under §108(b) (5) (described below)—the limitation for depreciable property is unlimited. ---Therefore if the taxpayer has limited non depreciable property attributes and wants to protect the taxpayer's depreciable property, don't make the election and although the taxpayer will lose all non depreciable property attributes under §108(b) (2) any excess COD income for the year should never be recognized. But see IRC Reg.1.108-7(a) (2). There is also a recapture rule that if basis is reduced under §1017 the recapture will result in ordinary income not capital gain to the extent of the COD. COD is ordinary income.
- Passive Activity Loss and Credit Carryovers
- Foreign Tax Credit Carryovers

**Election To Reduce Basis of Depreciable Property First:** If a debtor has available basis in depreciable property a debtor can elect to apply the reduction to depreciable property first. See §108(b) (5). The election to apply the reduction to depreciable property first is limited by §108(b) (5) (B) to not exceed the aggregate adjusted bases of depreciable property held by the taxpayer in the year following discharge. In other words, the taxpayer cannot make the election, have insufficient basis in depreciable property and protect the taxpayer's other tax attributes. If the taxpayer has insufficient depreciable property, then the taxpayer must reduce the other attributes available in the order contained in §108(b) (2). "depreciable property" is defined to include property that is depreciable if (1) the reduction in depreciation is allowable for the period following any reduction—i.e. the taxpayer must have allowable depreciation for the period after the COD income is deferred and (2) partnership interests can be depreciable property under certain circumstances, which include that the partners basis in depreciable property be reduced. The election is made on the taxpayer's return for the year in which the discharge occurs. §108(d) (9)

If the debtor has insufficient attributes to reduce COD income in full, and has reduced all of its attributes, any excess COD income is eliminated; it is not carried over into future years. See 1.108-7(a) (2). The Regulation suggests "all attributes" means "all attributes" including depreciable property. So to get this benefit a §108(e) (5) election needs to be made to reduce basis in depreciable property first, if the depreciable property basis is fully expended, then all other attributes need to be reduced to zero to insure all remaining COD income to disappears.

**The Last Clear Chance-When Does the taxpayer have to reduce attributes--** Even if the taxpayer incurs discharge of indebtedness income on the first day of a tax year, the taxpayer does not have to reduce the taxpayer's attributes until the first day of the next tax year. See §108(b) (4). Therefore, the taxpayer can use up all the taxpayer's tax attributes in the year of discharge and have none left and recognize no COD income at all. This creates some wild issues for Chapter 7 Trustees, based upon how the statutes are written-their "plain meaning" or lack thereof-- which will be discussed below when we address how each type of entity, is affected by COD exclusion in bankruptcy. Note, any tax avoidance scheme (i.e. selling property to a relative or a related company during the COD year and then buying it back the next year to preserve the basis) probably won't work.

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**Further Planning Possibilities:** The Statute gives the Debtor a choice between preserving its NOLs and perhaps basis in non depreciable property and reducing the basis in its depreciable property. Consideration needs to be made as to whether preservation of the NOLs has more or less tax benefit to the debtor than reduction of the basis in depreciable property. And further consideration needs to be made to the fact that there is no limit on the reduction of the basis in depreciable property, where a debtor who continues to have post-confirmation or post-discharge liabilities will lose all NOLs but only has to reduce basis up to the amount of the aggregate bases minus the liabilities after the discharge occurs.

### THE FUN BEGINS—APPLICATION OF 108 TO CHAPTER 7 AND 11 TRUSTEES, S CORPS, PARTNERSHIPS AND INDIVIDUAL DEBTORS

Although the statute appears relatively straightforward when read, applying it in the bankruptcy context is not clear at all.

**Individual Estates :** 26 U.S.C. §1398 provides that when an individual files a chapter 7 or a chapter 11, a separate bankruptcy estate is created, with the Trustee as the taxpayer with the responsibility for filing tax returns on behalf of the estate. Upon the commencement of an individual chapter 7 or 11 case, the estate is transferred all the debtors tax attributes listed in §1398(g) including operating losses, tax credits, basis, capital loss carryovers, the basis holding period for assets. Essentially the estate becomes the pre-petition debtor for tax purposes. Upon the termination of the estate, any unused attributes are returned to the debtor. See §1398(i). During the existence of the estate, an individual debtor is required to file its own tax return for its own income. In a chapter 7 this is an easy task because all post-petition income is not property of the estate. In a Chapter 11, it is much more complicated to sort out what if any separate tax return the individual debtor has to file. Chapter 11 tax return issues have become even more of a problem because under BAPCA individuals in Chapter 11 must include as part of the estate's income gross income from services after the commencement of the case. The IRS has issued Notice 2006-83 to attempt to tell Dip's and Chapter 11 Trustee's of individual estates how to allocate income between the estate and the individual in Chapter 11.

An individual has the exclusive right to elect to file a short year tax return and use attributes to offset income generated as of the Petition Date. See §1398(d) (2).

The separate estate rule does not apply to Chapter 12 and 13 cases.

#### When COD Income is Recognized in an Individual Chapter 7 Case?

The statutory framework provides that: "in a case under chapter 7 or 11 of the United States Code to which §1398 applies, for purposes of [attribute reduction under paragraph (b)] the estate (and not the individual) shall be treated as the taxpayer. The preceding sentence shall not apply for the purpose of applying section §1017 [basis reduction] to property transferred by the estate to the individual." §108(d) (8).

One unanswered question with regard to individual estates is when does the discharge and COD recognition event occur? Is it only at the end of the case? Or can some portion of it occur during the case, particularly if a compromise is reached that reduces a claim during the case which might give rise to COD income.

This author believes COD only occurs when the trustee makes his final distribution, or under BAPCA when an individual in Chapter 11 completes his plan payments, attribute reduction would occur on the first day of the tax year after the final distribution in Chapter 7 and/or the obtaining of the discharge in Chapter 11 (which is now similar to a Chapter 13 for individual debtors whether in a business or not). Theoretically, the Trustee is then supposed to reduce the attributes and transfer them back to the debtor when the case is terminated as provided by §1398(i), which would occur after final distribution. There is no form or reporting requirement for the Trustee to take such action. The Debtor is supposed to report on Form 982 in the year following the discharge the reduction of attributes made by the Trustee. This Trustee has never been contacted by any debtor to his memory regarding what attribute reductions have been made for purposes of the Debtor preparing and filing Form 982 in the 13 years the Trustee has been on the panel in New Hampshire.

The only case the author has discovered seems to miss the point entirely. See Firsdon v. U.S., 95 F.3d 444 (6<sup>th</sup> Cir 1996). In this case, the Trustee carried through NOLs from an individual chapter 11 estate for the entire case, closed the case in 1989 and never reduced NOLs or any other tax attributes during the 6 years of the case. The estate's final return showed a NOL of \$345,424. The Debtor's filed a refund claim for 1989 on its own return. The court expressed dismay with the Trustee for not reducing the tax attributes at all during his 6 year tenure as the estate's fiduciary and denied the refund claim. See *id* at 447-48. The Court also

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suggested that the Trustee should have reduced the attributes during the case and therefore the refund claim was denied both on the merits and on collateral estoppel grounds even though the Trustee's returns were accepted by the service.

The Firsdon case illustrates the difficulty courts have with 108 particularly in the context of individual estates. (1) The Court assumed the Trustee should have reduced attributes on the estate's tax return, even though as a bankruptcy matter the discharge did not occur until the final distribution, and therefore the Trustee is not required to reduce the attributes on the estate's return, just let the debtor know (if the debtor asks) what the reduction is; and (2) the Trustee has no reporting requirement to the Debtor of any reduction in attributes to be accounted for in the year following the discharge and (3) now under BAPCA the Debtor's post petition earnings are included in the income of the estate.

Exempt Property. There is no requirement to reduce basis in exempt property under §1017(c) (1). So in a non-business no asset case or an asset case which does not have non-exempt property or other attributes, COD issues will not result in adverse tax consequences.

### CORPORATIONS AND PARTNERSHIPS

26 U.S.C. §1399 for corporations and §1398(b) (2) for partnerships provide that when these entities file bankruptcy no separate taxable estates are created. There is no splitting of the Debtor and the estate as there is with individuals.

C Corp and Chapter 11: C corporations provide the most certain results. There are no pass through income or liability issues as there are with partnerships, S Corps and LLC that are not taxed as C Corps or sole proprietorships. COD income is recognized at the corporate level and attributes are reduced at the corporate level. In a Chapter 11 case the major issue usually involves attempts to preserve NOL and if a plan is confirmed that would be the discharge event, unless other debt is compromised by separate order "granting the discharge of indebtedness" (such as a sale with a debt compromise while the debtor is under the jurisdiction of the Court). See §108(d) (2). One problem that usually arises in the C corp context is that the C corp is usually an accrual taxpayer so §108(e) (2) will prevent avoidance of COD income because current deductions are available.

If a Chapter 11 C corp. is involved in a reorganization for tax purposes under 26 U.S.C. §368(a) (tax free reorganizations) and the taxpayer realizes COD income that is excluded under 108(a), the acquiring corporation's assets must reflect the basis reductions under 108(b). See IRC Reg. §1.108-7(c).

Debt for Debt Exchanges. A few issues to think about in the Chapter 11 corporation context that generates COD income if the corporation exchanges debt for debt (whether actual or deemed) the transaction results in a satisfaction of the old debt with the new debt. Under §108(e) (10) the amount paid for the old debt instrument is the "issue price" of the debt instrument (not its fair market value). COD income arises when the issue price of the new debt is less than the adjusted issue price of the old debt. Depending upon whether the company is publicly traded or not will determine how the debt instrument values are determined.

Stock for Debt Exchanges. In 1993 Congress eliminated the stock for debt exchange. §108(e)(8) provides that a debtor corporation that transfers stock to a creditor under a plan in satisfaction of a debt will recognize COD income to the extent the debt extinguished exceeds the FMV of the stock at the time of transfer.

Contributions of Debt to the Corporation. The acquisition by a debtor corporation of its indebtedness from a shareholder as a contribution to capital is not tax free as it is outside of §108. See 26 U.S.C. 118. See §108(e) (6). COD must be recognized to the extent the amount of the debt exceeds the shareholder's adjusted basis in the debt. If the debt has no adjusted basis (i.e. if it is services that have not been deducted) there will be no COD income. See §108(e) (2). With regard to S corps, §108(d) (7) (C) states that in a debt contribution situation, adjustments to an S shareholders debt basis will be made without regard to any §1367(b) (2) losses or distributions—meaning an s shareholder will not have to reduce his debt basis, and therefore generate COD income, by the amount of distributions and losses that have reduced his debt basis. The goal is to focus on the basis in the debt instrument standing by itself, not as its basis has been reduced by flow through distributions and losses

Corporate Chapter 7. A Corporation does not get a discharge in Chapter 7 under a plan or otherwise. In Friedman v Comr., T.C. Memo 1998-196 that an S corp that was liquidating in Chapter 7 did not get a discharge and therefore did not have COD income. So at least in a Corporate Chapter 7, COD may not arise because there is no bankruptcy discharge in the traditional

## INCOME TAX CONSEQUENCES OF COMMON COMMERCIAL BANKRUPTCY TRANSACTIONS

### CANCELLATION OF INDEBTEDNESS INCOME AND BANKRUPTCY

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bankruptcy sense.<sup>1</sup> A Corporation can separately recognize COD income under §108(a) (2)—the insolvency exception if the debt will never be collected, but this is a more amorphous determination and probably occurs when the final report is approved. As a practical matter a Chapter 7 the C Corp dies in bankruptcy so unless it becomes solvent, COD should not be a problem and attribute reduction will not be necessary since it occurs in the year after discharge. Generally, the only way COD could be an issue in 7 insolvency for a C Corp is if a debt is compromised during the case, then attribute reduction may be necessary and generate higher taxable income in future tax years. The situation is far more complicated for an S Corp, which has pass through tax consequences. S Corp issues are discussed below.

### PARTNERSHIPS AND S CORPORATIONS – THE PASS THROUGH NIGHTMARE

**Be very careful before putting a partnership, including an LLC taxed as a partnership or an S Corp in Chapter 7 or 11, because the tax liability flows through to the shareholder/partner and the insolvency exclusion and deferral provisions may not provide complete relief for the shareholder/partner.**

**With regard to an S Corp, a taxpayer has the absolute right to terminate the S election. This must be done before the bankruptcy. There are specific rules in Title 26 outlining how to terminate an S election. The most important consideration is that the termination must be prospective, it cannot be retroactive.**

Partnerships and S Corporations are flow through entities. To the extent there is COD income it will pass through to the owners based upon their share of the interest in the enterprise. This can lead to wild results in the partnership context where the income and liabilities can be split in different percentages among the partners.

#### S Corporations.

Under §108(d) (7) (A) sections §108(a) (exclusion for bankruptcy and insolvency), (b) (attribute reduction) and (g) (qualified farm indebtedness) **are applied at the corporate level for S Corps.** This creates much confusion. Theoretically, since the discharge is at the corporate level it should not matter whether an S Corp shareholder is solvent or insolvent. In an 11, a discharge will occur when a Plan is confirmed or in some other order that generates a debt discharge. There will be no COD income in Chapter 7 as a result of the bankruptcy because there will be no bankruptcy discharge. (But see footnote 1). If an S Corp in Chapter 7 is also insolvent, COD could occur when it is clear the debt will never be paid. It is unclear when this occurs, but should occur when the estate is fully administered. In practice, there has been an issue if a discharge occurs in an insolvency situation: (1) when it occurs; and (2) if the S shareholder is solvent and there are insufficient attributes to offset the COD income, whether the S Shareholder has to recognize COD income equal to the difference between the available attributes and COD income realized.

This issue may have been clarified by Treas. Reg. 1.108-7(a) (2) which applies to COD income occurring after May 10, 2004. The Treas Reg. states that if there are insufficient attributes in the year of discharge, the indebtedness is permanently excluded from income if COD income exceeds the sum of all taxpayer's tax attributes. The regulations provide the "permanent exclusion" language only if the taxpayer reduces all attributes by electing to reduce both depreciable property and then the remaining attributes available to the Taxpayer. *Id.* Presumably, if the election is not made, COD income may be realized by the taxpayer if there are insufficient non depreciable property assets to offset the COD income. Even if the excess is excluded, in future years the taxpayer will not have a basis in any assets, including assets not administered by the Trustee and abandoned either during or at the close of the case.

#### Gitlitz and amendments to §108.

In 2000 the Supreme Court held in *Gitlitz v. Comr.*, 531 U.S. 206 (2000), under the "plain meaning rule" that discharge of indebtedness was an "item of income" under section 61 of the internal revenue code and therefore, since the S corporation was insolvent, the shareholder could increase his basis by the amount of COD income under §1366(a)(1) even though the income was deferred and the attributes not reduced until the first day of the following tax year. This, in effect, gave the S corp shareholder increased basis from COD income that was deferred in the year realized, allowing shareholders to generate losses on their

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<sup>1</sup> The idea that there is a fundamental difference between a corporate and individual liquidation for COD recognition purposes does not reflect reality. The discharge an individual receives 120 days into a Chapter 7 has nothing to do with the discharge of indebtedness income that will be generated when the final distribution is made in the case. In reality the discharge for COD purposes should occur in both individual and corporate cases at the same time, when the final report is approved quantifying the amount of debt that will not be paid. 288

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personal tax returns even though the income was deferred. In essence the “NOLs” could be currently used and unavailable for attribute reduction in the following year.

Congress quickly closed this hole in 2002 by amending §108(d) (7) (A) to state that 26 U.S.C. §1366(a) cannot be increased by any amount of excluded COD income. As stated above, whether this also solves all problems for S shareholders who have insufficient attributes to offset “excluded COD income” for an insolvent corporation should be clear, but it may not be..

S corporations do not have NOL's. Losses that would generate NOL's flow through to S corp. Stockholders. To the extent that flow through losses are not used in the year they were generated, they are titled “suspended losses” and reported on the K -1 of each taxpayer. If the losses in a given year exceed the basis a shareholder has in his stock and debt the company owes to him they must be suspended. In order to capture these suspended losses for tax attribute reduction purposes §108(b) (2) (A) provides that any disallowed losses under §1366(d) (1) is treated as an NOL for the taxable year. Unlike a partnership, S corporation shareholders only have bases in their stock and debts owed by the company to them. So their losses and deductions cannot exceed these amounts. So S shareholders are often faced with big problems in bankruptcy cases because their basis is limited, and they usually have already taken all losses and have a zero basis. Therefore any post-petition income will be passed through to them. Even if COD income is deferred it will reduce any suspended losses (which are treated as NOLs) and the shareholders will likely have much larger pass through gain in the future.

S Corps cannot treat their stock as depreciable property, and elect to reduce their basis in their stock to preserve suspended losses. Partners can. See §1017(b) (3) (C).

#### **Partnerships.**

In order to determine whether there is COD income in a partnership or LLC taxed as a partnership that has filed bankruptcy, **the practitioner has to look at whether each individual partner is solvent, insolvent or in bankruptcy. §108(e) (6)(exclusion determined at the partner level not the partnership level).** At the partnership level, COD is treated as an item of income which is allocated separately to each partner under §702(a). At the partner level §705(a) provides that the partnership agreement determines how income is distributed among the partners and such distribution needs to have substantial economic effect.

Similar to this issue in Gitlitz, the issue arises whether an insolvent partner who excludes COD income can increase his basis in his partnership interest since there is “no current income”. The Sixth Circuit held that the basis should not be increased. See Babin v. Commr. 23 F.3d 1032 (6<sup>th</sup> Cir 1994). The IRS has stated it would not follow Babin but allow the partner to increase basis by the excluded COD income. TAM 9739002. The reason the service treats this differently from an S corp is that under 26 U.S.C. §752 a decrease in liabilities is a distribution to partners. So if a partner cannot increase his basis by COD income, then he will have gain from the deemed distribution from the reduction of debt, and will have current income tax liability. By allowing COD to be included under §705 for an insolvent partner so that basis can be increased (as long as the partnership agreement has substantial economic effect) the basis increase will offset the deemed distribution that occurs from the reduction of partnership liabilities from the discharge of debt. This prevents COD from creating gain unless the income and liabilities are not 1:1, which they do not have to be under the partnership agreement. This gain exclusion would apply to a solvent partner as well. Even if there is no gain, such partner would have to recognize COD income because he isn't insolvent. See Tax Management Portfolios, Discharge of Indebtedness, Bankruptcy and Insolvency, 540-2<sup>nd</sup>. 102-103. (2007).

A partner can elect under §108(b) (5) to reduce the basis in his partnership interest. §1017(b) (3) (C). The election has to be made separately by each partner, not the partnership. Section 703(b). With respect to inside basis reduction under §108(b) (5) the regulations to §1017—§1.1017-1(g) (2)(ii)(A), (B) and (C) provide the mechanism for obtaining various percentages of partnership consents required to make the §108(b)(5) election for inside basis.

#### **REPORTING REQUIREMENTS**

**Debtor.** The Debtors that exclude COD income from gross income or reduce tax attributes under §108 must file a Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness and §1082 Basis Adjustments) to their return in the year the attributes are reduced (the tax year immediately after the year the COD income is incurred and deferred.)

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**Creditor.** Section 6050P requires “applicable entities” to file information returns that discharges debt to any person of more than \$600. These would include organizations engaged in the trade or business of lending money. The report must be made on form 1099-C. The regulations provide that reporting is required when there is an “identifiable event” which exclusively include

- Bankruptcy if the debt was acquired for business or investment purposes, consumer reporting is not required
- Foreclosures and receivership discharges
- Expiration of the statute of limitations if the SOL defense is upheld by a final non-appealable judgment
- Strict foreclosure
- Cancellation in a probate proceeding
- Cancellation through a settlement agreement
- Discharge by “discontinuing collection activity”
- Expiration of a 36 month testing period in which no payment is made—the period is suspended during a bankruptcy.

See Regs §1.6050P-1 for more details.

**INCOME TAX CONSEQUENCES OF COMMON COMMERCIAL BANKRUPTCY TRANSACTIONS**

**NET OPERATING LOSSES (NOL's)**

**What They Are And The Issues Related To Their Use and Preservation**

Presented by: *Keith D. Lowey, CPA, President – Verdolino & Lowey, P.C.*  
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Includes excerpts

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### NET OPERATING LOSSES (NOL's)

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**Net Operating Loss Defined.** Simply stated, an NOL (net operating loss) is the excess of allowable deductions over gross income, computed under the law in effect for the loss year, with the required adjustments (Code Sec. 172(c) and (d); Reg. §§1.172-2 and 1.172.3).

Nearly every taxpayer is allowed to carryback a net operating loss (NOL) from a trade or business to apply as a deduction against prior income and to deduct from succeeding years' income any unabsorbed loss (Code Sec. 172(b)). Taxpayers entitled to the carryback and carryover privilege include:

1. corporations (other than those specifically excepted);
2. individuals;
3. estates and trusts;
4. common trust fund participants; and
5. partners who may deduct allocable partnership loss.

Generally, no NOL deductions are available to partnerships and S corporations, but their investors may use their distributive shares to calculate individual NOLs.

The NOL carryback or carryover is generally that part of the NOL that has not previously been applied against income for other carryback or carryover years (Code Sec. 172(b) (2); Reg. §1.172-4). In computing the taxable income of an intervening year that must be subtracted from an NOL to determine the portion still available to carry to subsequent (or preceding) years, various adjustments must be made (Reg. §1.172-5) including (1) personal and dependency exemptions not being allowed; (2) for non-corporate taxpayers – capital losses are deductible only to the extent of capital gains; among others.

Useful life of NOL's – generally can be carried back to the two years preceding the loss year and then forward to the 20 years following the loss year (old rules – years beginning before August 6, 1997 – it was 3 years back and 15 years forward).

A taxpayer may elect to waive the entire carryback period (Code Sec. 172(b) (3)). If the election is made, the loss may be carried forward only. The election must be made by the return due date (including extensions) for the tax year of the NOL. The election is irrevocable. The election may also be made on an amended return filed within six months of the due date of an original timely return (excluding extensions).

Forms to use for an NOL – Individuals, estates, and trusts compute the NOL for the loss year and the carrybacks and any carryforward on Form 1045 (Code Sec. 6411; Reg. §1.6411.1). Form 1045 is filed to claim a quick refund for the excess taxes paid in the carryback years that are attributable to the NOL. Form 1045 may only be used if filed within one year after the close of the NOL year. As an alternative to Form 1045, an individual may file Form 1040X for each carryback year to claim a refund. Estates and Trusts file an amended Form 1041 (there is no Form "1041X"). If an amended return is filed the taxpayer must still attach the NOL computation using the Form 1045 computation schedules.

Corporations may file for a quick refund using Form 1139. A separate Form 1120X may be filed in place of Form 1139 for each carryback year.

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Limitations on the use of NOL's – I.R.C. section 382 loss limitation provisions are relevant only in the event of a change of ownership of a loss corporation. In general, an ownership change is a change of more than 50 percentage points in ownership of the value of stock of the loss corporation within a three-year period. A loss corporation is defined in I.R.C. section 382(k)(1) as a corporation entitled to use a net operating loss carryover, a current net operating loss, or a built-in loss. The IRC provides that a change in ownership can occur either as a result of an owner shift involving a 5-percent shareholder or an equity structure shift.

An ownership change occurs if, on a testing date, the percentage of stock of a loss corporation owned by one or more 5-percent shareholders has increased by more than 50 percent points relative to the lowest percentage of stock of the old loss corporation owned by those 5-percent shareholders at any time during the testing period (generally, three years). The determination of whether an ownership change has occurred on a date on which there has been an ownership shift (a "testing date") is made by comparing the increase in value in percentage stock ownership (if any) for each 5-percent shareholder as of the close of the testing date, with the lowest percentage of stock owned by each 5 percent shareholder during, the three-year testing period. Stock owned by persons who own less than 5 percent of a loss corporation is generally treated as stock owned by one or more 5 percent shareholders.

In determining whether an ownership change has occurred, the general rule is that changes in the holding of all "stock" are taken into account, except preferred stock (defined in I.R.C. section 1504(a)(4)) that is nonvoting and nonconvertible, and that does not participate in corporate growth and has a reasonable redemption or liquidation premium. Although such preferred stock is not counted as stock for purposes of determining whether there is an ownership change, it is generally included as stock for purposes of determining the value of the loss corporation.

**An NOL that arises before a change in ownership can be used in any period after the change, subject to the annual section 382 limitation.**

**The section 382 limitation generally restricts the amount of income against which prechange NOLs can be applied in any post-change taxable year to the product of the fair market value of the stock of the corporation immediately before the ownership change and the long-term tax-exempt rate. Any NOL limitation not used because of insufficient eligible taxable income in a given year is added to the section 382 limitation of a subsequent year.**

**Until an ownership change takes place, a loss corporation can use all of its losses without a "section 382 limitation" and none of the numerous restrictions and limitations of section 382 applies.**

### **NOLs in a Corporate Bankruptcy**

Corporations under the jurisdiction of a court in a title 11 or similar case may be subject to special provisions of IRC section 382. In general, although a bankrupt corporation undergoes an ownership change pursuant to section 382(g), section 382(l)(5) provides that the typical limitation will not apply if certain conditions are met. Instead of the typical limitation, any NOL carryover may be subject to certain limited reductions.

Alternatively, bankrupt corporations meeting the conditions of section 382(l)(5) may elect out of that section and apply section 382(l)(6). Under section 382(l)(6), the typical limitation will apply; however the NOL carryover will not be reduced and the value of the bankrupt corporation will be increased for certain items. The increase in value will increase the section 382 limitation thereby increasing the loss corporation's ability to use its net operating loss.

IRC section 382(l)(5) provides that the section 382 limitation will not apply to a corporation if (1) immediately before an ownership change, the corporation was under the jurisdiction of a court in a federal bankruptcy proceeding or similar case, and (2) after an ownership change, the pre-change shareholders and "qualified creditors" of the loss

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corporation own stock constituting 50 percent or more of the vote and value of the new loss corporation, as a result of being shareholders or “qualified creditors” immediately before such change (“the continuity requirement”). “Vanilla preferred” stock is not counted in determining this continuity requirement, but parent company stock will be counted, provided the parent company is also in bankruptcy.

For purposes of determining whether the continuity requirement has been met, options are deemed exercised if their exercise would cause the transaction to fail to satisfy the continuity requirement. A qualified creditor can, however, treat an option actually exercised during the three-year period following the ownership change as stock outstanding for purposes of determining whether the plan qualifies under I.R.C. section 382(1)(5). Thus, a plan that may fail to qualify for I.R.C. section 382(1)(5) treatment due to the deemed exercise of options, which would defeat the continuity requirement, could be revitalized so as to qualify for I.R.C. section 382(1)(5) treatment, by the actual exercise of options by qualifying creditors.

A “qualified creditor” is the beneficial owner of “qualified indebtedness” of the loss corporation immediately before the ownership change. A qualified creditor owns stock of the loss corporation as a result of satisfaction of “qualified indebtedness” pursuant to the bankruptcy reorganization plan.

“Qualified indebtedness” is (1) indebtedness owned by the same beneficial owner for the continuous 18-month period prior to the bankruptcy filing or (2) indebtedness that arose in the ordinary course of business of the loss corporation and has always been owned by the same beneficial owner. Special rules apply if indebtedness is a large portion of a beneficial owner’s assets. For purposes of determining whether qualified indebtedness exists, regulations provide special rules for indebtedness not owned by a 5-percent shareholder or a 5-percent entity (the latter defined as an entity through which a 5-percent shareholder owns an indirect ownership interest in the loss corporation). Special “actual knowledge” exceptions may also apply.

If I.R.C. section 382(1)(5) applies, two special rules must be followed:

1. Net operating losses are reduced by interest paid or accrued on indebtedness converted to stock during any taxable year ending during the three-year period preceding the taxable year in which the ownership change occurs, and during the period of the tax year of the ownership change before the change date.
2. After an ownership change that qualifies for the bankruptcy exception, a second ownership change during the following two-year period will result in a zero section 382 limitation with respect to the second ownership change.

In general, following an ownership change pursuant to I.R.C. section 382, a corporation must continue its business enterprise during the two-year period beginning on the change date. If a corporation does not continue its business enterprise for the requisite two-year period, the section 382(a) limitation is deemed to be zero. If a corporation is subject to I.R.C. section 382(1)(5), however, the continuity of business enterprise requirement is waived.

#### **I.R.C. Section 382(1)(6) - General Provisions:**

IRC section 382(1)(5)(H) provides that a debtor in bankruptcy may elect not to have the section 382(1)(5) provisions apply. Regulations govern the manner in which the debtor makes this election. In addition, even if I.R.C. section 382(1)(5) does not apply, section 382(1)(6) will apply if a corporation subject to a title 11 or similar case undergoes an ownership change.

The regulations provide that the election not to have the provisions of I.R.C. section 382(1)(5) apply is irrevocable. The regulations also require that the election be made on the return of the loss corporation for the tax year including

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or ending with the change date. Because the election is irrevocable, corporations are precluded from either making the election after a second ownership change or making a protective election that is revoked after the expiration of the two-year period.

Because the election will not have to be made until the due date of the return (including extensions), proper selection of the effective date can still give the taxpayer extended time in which to make the election not to apply I.R.C. section 382(1)(5).

I.R.C. section 382(1)(6) provides that the debtor may calculate the section 382 limitation based on the enhanced value of the corporation after the ownership change occurs. Thus, the debtor would be able to use the value of the equity on emergence from chapter 11 rather than the value before debt was exchanged for stock.

Regulations under I.R.C. section 382 provide guidance on determining the value of a loss corporation that is emerging from bankruptcy and elects to apply the provisions of I.R.C. section 382(1)(6).

#### **Continuity of Business Enterprise:**

As stated above, the continuity of business enterprise requirement of I.R.C. section 382(c) is waived if a corporation is subject to section 382(1)(5); however, if a corporation is subject to section 382(1)(6), the continuity of business requirement must be met.

#### **Comparison of I.R.C. Section 382(1)(5) and (1)(6):**

Note that several factors must be considered in deciding whether to use the bankruptcy exception:

- The present value of the projected benefit from net operation losses allowable under the section 382 limitation should be compared with the present value of the benefit of the net operating loss remaining after determining the effect of I.R.C. section 382(1)(5).
- The extent to which the remaining net operating loss under the bankruptcy exception may be lost due to a change in ownership within two years should be carefully considered. If a change of ownership appears likely, then it may be best to elect not to apply the bankruptcy exception.
- Trading of claims prior to the confirmation of the plan may cause qualifying creditors and stockholders to own less than 50 percent of the reorganized debtor, and thus to fail the continuity requirement of I.R.C. section 382(1)(5).
- The investment of additional capital may result in the loss of significant tax benefits if new investors will own more than 50 percent of the equity. Thus, the potential tax benefit that may be lost if I.R.C. section 382(1)(5) is not applied should be compared with the benefit to the debtor of attracting additional capital.
- If discontinuation of the business within two years is planned, the section 382(1)(5) bankruptcy exception should generally be used.

Thus, a loss corporation needs to review carefully its overall tax situation to determine whether I.R.C. section 382(1)(5) is the most beneficial route to take. Particular attention must be paid to the corporation's pre-bankruptcy interest expense and any forgiveness of indebtedness income that will arise as a result of its bankruptcy.

## INCOME TAX CONSEQUENCES OF COMMON COMMERCIAL BANKRUPTCY TRANSACTIONS

### NEGATIVE TAX CONSEQUENCES REALIZED BY EQUITY HOLDERS IN PASS THROUGH ENTITIES

Presented by: *Richard P. Finkel, CPA, CFE, CIRA – Blum, Shapiro & Co., P.C.*

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Limited Liability Companies (LLCs), Sub Chapter S Corporations and Partnerships are pass through entities. These entities do not pay taxes. Income or loss generated by these entities passes through to the members, shareholders or partners.

There are several advantages to organizing as a pass through entity. Business losses can be deducted individually by owners and some of these entities may provide liability protection for their owners. However, when a pass through entity files for bankruptcy protection these advantages usually disappear.

Post-petition taxable income will still pass through to the owners, creating phantom income. The owners no longer have the economic benefit of ownership and even though they are taxed on the income, no cash is distributed to them to pay the tax. This holds true even for single member LLCs.

Bankruptcy practitioners should approach the filing of a Chapter 7 or Chapter 11 petition for a pass through entity with a great deal of caution.

A PICTURE IS WORTH A THOUSAND WORDS.

#### FACT PATTERN

##### PJS & BPS (Married Couple)

- Voluntary Chapter 11 Petition – January 11, 2002
- Assets:

(PJS) 550 Shares in CC, Inc.	\$ 1,000,000
(PJS) 50 Shares in PJS, Inc.	472,500
(BPS) 50 Shares in PJS, Inc.	472,500
	<u>\$ 1,945,000</u>
- Unsecured Creditors:

Misc. & Lawsuits	\$ 437,561
DJ, Inc.	1,218,885
GS	1,218,885
	<u>\$ 2,875,331</u>

##### CC, Inc. (Chapter C Corporation)

- Voluntary Chapter 11 Petition – December 18, 2002
- Assets:

200 Acres of Land	<u>\$ 5,000,000</u>
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- Unsecured Creditors:

PJS	\$ 1,413,318
DJ, Inc.	1,218,885
GS	1,218,885
	<u>\$ 3,851,008</u>
- Tax Basis in Land \$ 1,500,000

## INCOME TAX CONSEQUENCES OF COMMON COMMERCIAL BANKRUPTCY TRANSACTIONS

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#### FACT PATTERN (continued)

##### PJS, Inc. (Sub Chapter S Corporation)

- Voluntary Chapter 11 Petition – January 15, 2003
- Assets:
  - 47 Acres of Land **\$ 3,000,000**
- Unsecured Creditors:
  - Property Tax – Priority \$ 10,000
  - DJ, Inc. 1,218,885
  - GS 1,218,885
  - \$ 2,437,770**
- Tax Basis in Land **\$ 250,000**
- Case Jointly Administered
- Cases Converted to Chapter 7 – September 15, 2003
- All Cases Assigned to One Trustee
- Trustee Abandons Stock in PJS, Inc.
- Receives Offer for Land \$ 2,450,000
- Non Refundable Deposit \$ 100,000
- Extension of Closing Date \$ 250,000

#### 2006 – PJS, INC. TAX CONSEQUENCES

- Income \$ 350,000
- Administrative Expense (24,167)
- Net Taxable Income **\$ 325,833**
  
- Taxable Income to PJS \$ 162,917
- Taxable Income to BJS \$ 162,916

#### 2007 – PJS, INC. TAX CONSEQUENCES

- Trustee Receives New Offer \$ 1,250,000
  
- Income from Sale \$ 1,250,000
  - Less Basis 250,000
  - Gain on Sale **\$ 1,000,000**
  
- Taxable Income to PJS \$ 500,000
- Taxable Income to BJS \$ 500,000

#### CC, INC.

- Offer to Purchase \$ 1,100,000
- Tax Basis in Land 1,500,000
  
- Net Loss **(\$ 400,000)**

**INCOME TAX CONSEQUENCES OF COMMON COMMERCIAL BANKRUPTCY TRANSACTIONS**

**JUDICIAL PERSPECTIVES / CONSIDERATIONS**

Presented by: *Honorable Robert E. Gerber, United States Bankruptcy Court, Southern District of New York*  
*Judge\_Gerber@nysb.uscourts.gov, (212) 668-5660*

**CASE ABSTRACTS TO BE PROVIDED**

- In re Prudential Lines Inc. 928 F.2d 565, 2d Cir 1991
- In re UAL Corp. 412 F.3d 775, 7th Cir 2005