Tax Complications of Bankruptcies in Difficult Economic Times

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Given the current state of the economy, it should come as no surprise that business related bankruptcy filings increased 41.6 percent and non-business bankruptcies increased 28.4 percent between June 30, 2007, and June 30, 2008, with more than one million Americans filing for bankruptcy during calendar year 2007, according to the Administrative Office of the U.S. Courts.

It is essential that the tax implications of a bankruptcy proceeding, for both individuals and businesses, be considered when assessing the viability of a filing under the Bankruptcy Code. Some of the more critical tax planning aspects of bankruptcy filings are discussed below. However, this article only touches on a few of the vast array of tax considerations that should be evaluated by both individuals and businesses when considering a bankruptcy filing.

Business Tax Considerations

Chapters 11 and 12 of the Bankruptcy Code give rise to some unique tax planning opportunities. One of the principal tax planning considerations in a reorganization of both a troubled company and its creditors is preserving the company's net operating losses, or NOLs, and other tax attributes. Restructurings frequently cause a change in control that may limit the debtor's use of its NOLs.

Under §382 of the Internal Revenue Code, or IRC, a restructured entity's NOLs existing prior to the restructure are limited. IRC §382 generally applies to situations where corporations with NOLs undergo a change in ownership or a change in equity structure, and it limits the restructured corporation's NOLs to an amount equal to the company's equity value immediately prior to the equity shift or ownership change multiplied by the long term tax exempt rate, which is provided periodically by the Internal Revenue Service.

In addition, tax issues surrounding income related to the cancellation of debt, or COD, should be considered. The IRS considers debt that is canceled, in full or in part, to be taxable income to the debtor (subject to exceptions) to the extent the financial position of the debtor has been improved by the debt cancellation. The exclusion of COD income can substantially reduce or even eliminate NOLs and other tax attributes of the debtor company.

Taxpayers that exclude COD amounts from gross income because they are either insolvent or bankrupt are required to reduce their tax carryovers in the following order:

- NOLs from the taxable year of discharge are reduced first, dollar for dollar, followed by NOL carryovers in the order in which they arose.
- General business credits are reduced 33.3 cents on the dollar, in the order they would otherwise be used against taxable income.
- Alternative minimum tax credits that are available as carryovers from the year of debt discharge as credits against future regular tax are reduced at the rate of 33.3 cents on the dollar.
- Capital loss carryovers are reduced, dollar for dollar, first from the year of discharge and then in the order in which they arose.
- The basis of assets, both depreciable and non-depreciable, is reduced dollar for dollar.
- Passive activity losses and credits are reduced by 33.3 cents on the dollar.
- Foreign tax credit carryovers to or from the taxable year of discharge are reduced, 33.3 cents on the dollar, in the order in which they arose.

Opportunities are also available for taxpayers to elect to reduce the basis of depreciable property in lieu of the previously listed tax attribute reductions, in accordance with IRC §108(b)(5). However, these are complex evaluations, and it is critically important to consult with a qualified tax attorney or CPA when proceeding through reorganization to ensure that the unique tax planning opportunities during bankruptcy are not overlooked.

Taxation of the Bankruptcy Estate

The tax of a bankruptcy estate is generally computed in the same fashion as the tax liability of an individual. The bankruptcy estate is entitled to one personal exemption and might utilize the same standard deduction available to a married person filing separately if it does not itemize deductions. The tax rates for married people filing separately also apply and gross income of a bankruptcy estate includes income of the debtor to which the estate is entitled, received or accrued after commencement of the bankruptcy proceedings. The trustee of a Chapter 7 bankruptcy estate is responsible for the computation and payment of the tax and must establish the estate's tax year which can only be changed once and without IRS approval.

Taxation of the Debtor

As previously noted and subject to exceptions, the IRS considers debt that is canceled to be taxable income to the debtor. Therefore, a credit card company settlement can result in the unintended consequence of an income tax bill from the IRS. Herein lies a tax planning opportunity. Because canceled debt is excluded from income only in situations where more is owed to creditors than the total value of a debtor's assets, a Chapter 7 bankruptcy filing is one alternative to avoiding tax on canceled debt. Debt that is canceled in a bankruptcy case is not considered to be income to the bankrupt debtor. In other words, a solvent debtor, in most cases, realizes income from the discharge of a debt, however debtors who are insolvent in bankruptcy do not. Therefore, it is important to consult with a qualified CPA and lawyer before evaluating the advantages and disadvantages of a Chapter 7 liquidation. In the case of a Chapter 11 debtor, its debt discharge is totally excluded from income without regard to solvency.

Discharge of Income Tax Liabilities

In limited situations income tax debts may be eligible for discharge under Chapter 7 or Chapter 13 of the Bankruptcy Code. However, tax debts that arose from unfiled tax returns are not dischargeable. To qualify for discharge, the tax obligations of the bankruptcy petitioner must meet the following five criteria:

- The due date for filing the tax return for which the tax debt arose is at least three years prior to the date the bankruptcy petition is filed.
- The tax return for which the tax debt arose was filed at least two years prior to the date the bankruptcy petition is filed.
- The tax assessment is at least 240 days old on the date the bankruptcy petition is filed.
- The tax return was not fraudulent or evasive in nature in any way.
- The taxpayer has not been previously found guilty of tax evasion.

Missing any of these conditions by one day will void dischargeability.

Additionally, before a Chapter 7 or Chapter 13 bankruptcy can be granted, the bankruptcy petitioner is required to prove that the four previous income tax returns have been filed with the IRS.

Conclusion

With the economy in its current state, more individuals and businesses are filing for bankruptcy in order to obtain a fresh financial start. Bankruptcy is a complex and time-consuming endeavor with significant tax implications, many of which are outside the scope of this article. Therefore, it is vital to consult with a CPA or lawyer to determine if and when bankruptcy makes sense.

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