

## LESSON 8

### THE TAXABLE ESTATE

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#### I. INTRODUCTION

On December 24, 1980, President Carter signed into law the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 1980-2 C.B. 607. This legislation adapted some of the general concepts of federal income taxation to the particular factors inherent in bankruptcy. The filing of a bankruptcy petition creates a bankruptcy estate, which generally consists of all the assets of the person filing the bankruptcy petition. A separate taxable entity is created if the bankruptcy petition is filed by an individual under Chapter 7 or Chapter 11 of the Bankruptcy Code. The tax obligations of the debtor vary depending on the bankruptcy chapter under which the petition was filed. Additional information concerning the debtor's tax obligations can be found in IRS Publication 908, Bankruptcy Tax Guide (Rev. Oct. 2012).

#### II. DEBTOR AND BANKRUPTCY ESTATE AS SEPARATE ENTITIES

The bankruptcy estate of an individual is treated as a separate taxable entity for federal income tax purposes. The separate entity rules under I.R.C. § 1398 apply if a bankruptcy case involving an individual debtor is brought as a liquidation under Chapter 7 or a reorganization under Chapter 11. Except in any case to which section 1398 applies, no separate taxable entity results from the commencement of a bankruptcy case. I.R.C. § 1399. If a bankruptcy case

involving an individual is commenced, but is subsequently dismissed by the bankruptcy court, the estate is not treated as a separate taxable entity. I.R.C. § 1398(b)(1). Upon such a dismissal, Publication 908 states that if tax returns were filed for the estate, amended returns must be filed to move income and deductions from the estate's returns to the debtor's returns.

No separate taxable entity results from commencement of a bankruptcy case involving a partnership or corporation. I.R.C. § 1399. Accordingly, the trustee of a partnership in bankruptcy is required to file annual information returns for the partnership. I.R.C. § 6031. Also, the trustee of a corporation in bankruptcy is required to file annual income tax returns and pay corporate income tax for the corporation. I.R.C. § 6012(b)(3); Rev. Rul. 79-120, 1979-1 C.B. 382.

### **III. DEBTOR'S ELECTION TO CLOSE TAXABLE YEAR**

An individual debtor in a Chapter 7 or Chapter 11 case may elect to close the taxable year as of the day before the date on which the bankruptcy case commences. If the election is timely made, the debtor's calendar year is divided into two short taxable years of less than 12 months each. The first year ends on the day before the commencement date; the second year begins on the commencement date. I.R.C. § 1398(d)(2)(A). If the election is not made, the commencement of a bankruptcy case does not affect the taxable year of an individual debtor. I.R.C. § 1398(d)(1).

As a result of the debtor's making the election, the federal income tax liability for the first short taxable year becomes an allowable unsecured priority claim of the bankruptcy estate, if a claim is timely filed. If the election is made, the debtor is required to annualize his or her taxable income for each short taxable year in the same manner as if a change of annual accounting period had been made. I.R.C. § 1398(d)(2)(F). If the debtor does not make the election, no part of the debtor's tax liability for the year in which the bankruptcy case is commenced is collectible from the estate, but is collectible directly from the individual debtor.

The election is available only in cases to which section 1398 applies. If the debtor files a qualifying election, but the case is subsequently dismissed, the election is not effective. I.R.C. § 1398(b)(1). If the debtor's case is a Chapter 7 no-asset case, the election is unavailable. I.R.C. § 1398(d)(2)(C). The election must be made on or before the 15th day of the fourth month following the commencement date, i.e., by the date on which a return would be due for the first short taxable year if the election were made. The due date is determined without regard to any extension of time for filing such return. See Treas. Reg. § 301.9100-14T(d), concerning the time and manner of making the election.

The election can be made by filing the return for the first short period on or before the due date, or by submitting a statement of election attached to an application for extension of time for filing the first short period return on or before such date. To facilitate processing, the taxpayer should write "Section 1398 Election" at the top of the tax return. If a joint election is to be made with the extension of time, the debtor's spouse must join in the extension request and the statement of election. Treas. Reg. § 301.9100-14T(d).

If the debtor making the election is married when the bankruptcy case commenced, the debtor's spouse can join in the election to close the taxable year, but only if the debtor and the spouse file a joint return for the first short taxable year. I.R.C. § 1398(d)(2)(B). The filing of a joint return for the first short taxable year does not require the debtor and the spouse to file a joint return for the second short taxable year. The spouse may join in the election even though the spouse did not join in filing a bankruptcy petition.

#### **IV. COMPUTATION OF BANKRUPTCY ESTATE'S TAX LIABILITY**

The gross income of the bankruptcy estate of an individual consists of: (1) any gross income of the individual debtor (other than any amount received or accrued as income by the debtor before the commencement of the case) which under bankruptcy law constitutes property of the estate; and (2) the gross income of the estate beginning on the date the case is commenced. I.R.C. § 1398(e)(1). The estate succeeds to specified income tax attributes of the debtor, including attributes specified in regulations under section 1398(g)(8). The attributes include the debtor's net operating loss carryovers, capital loss carryovers, and credit and charitable contribution carryovers determined as of the first day of the debtor's taxable year in which the case commences. For a list of the tax attributes, see section 1398(g) of the Code and sections 1.1398-1, 1.1398-2 and 1.1398-3 of the Income Tax Regulations.

An amount paid or incurred by the bankruptcy estate is deductible or creditable by the estate to the same extent that item would be deductible or creditable by the debtor had the debtor remained in the same trades, businesses or activities after commencement of the case as before and had the debtor paid or incurred such amount. I.R.C. § 1398(e)(3). The same test is applied to determine whether amounts paid by the estate constitute wages for purposes of federal employment taxes. I.R.C. § 1398(e)(3). Administrative expenses not used in the current year can be carried back by the estate three years, but only to a taxable year of the estate, and forward seven years. I.R.C. § 1398(h)(2)(B). If the bankruptcy estate itself incurs a net operating loss apart from losses passing to the estate from the individual debtor, the bankruptcy estate can carry back its net operating losses not only to previous taxable years of the estate, but also to

taxable years of the individual prior to the year in which the case commenced. I.R.C. § 1398(j)(2)(A).

Except as otherwise provided in section 1398, the taxable income of the bankruptcy estate is computed in the same manner as in the case of an individual. I.R.C. § 1398(c)(1). The estate is allowed a personal exemption under I.R.C. § 151. The standard deduction, for estates which do not itemize, and the tax rate schedule applicable to the estate, are the same as for married individuals filing separate returns. I.R.C. § 1398(c). The trustee is required to file a federal income tax return on behalf of the bankruptcy estate for any year in which the estate's gross income is not less than the sum of the exemption plus the basic standard deduction under I.R.C. § 63(c)(2). I.R.C. § 6012(a)(9), redesignated as I.R.C. § 6012(a)(8) for tax years beginning after December 31, 2010. The estate is permitted to change its annual accounting period, or taxable year, one time without obtaining approval of the Service. I.R.C. § 1398(j)(1). This rule permits the trustee to effect an early closing of the estate's taxable year prior to the expected termination of the estate, and to submit a return for the short year for an expedited determination of tax liability pursuant to Bankruptcy Code § 505(b).

The estate's federal income tax return is open, on written request, to inspection by or disclosure to the individual debtor. I.R.C. § 6103(e)(5)(B)). Disclosure is necessary so that the debtor can properly determine the amount of tax attributes to which the debtor would succeed on termination of the bankruptcy estate.

**Note:** Under Bankruptcy Code § 1115, added by the BAPCPA, the definition of “property of the estate” in individual Chapter 11 cases is identical to that applicable in Chapter 13 cases (see section 1306 for the definition). Notice 2006-83, 2006-2 C.B. 596, explains how section 1115 affects individual Chapter 11 cases. The explanation provides, in part, that “As a result of the enactment of section 1115, the bankruptcy estate, rather than the debtor, must include in its gross income both (1) the debtor’s gross earnings from his or her performance of services after the commencement of the case (“post-petition services”) and (2) the gross income from property acquired by the debtor after the commencement of the case (“post-petition property”). I.R.C. § 1398(e)(1). The gross earnings from post-petition services include wages and other compensation earned by a debtor who is an employee and self-employment income earned by a debtor who is a self-employed individual.” See Section 1, “Purpose,” of the Notice.

## **V. ABANDONMENT OF PROPERTY FROM THE ESTATE**

If property of the bankruptcy estate is abandoned to the debtor under section 554 of the Bankruptcy Code upon “termination of the estate”, the abandoned

property passes to the debtor and there is no taxable event to the estate. I.R.C. § 1398(f)(2). Also, the debtor succeeds to the estate's basis and holding period in the property when the bankruptcy estate terminates. I.R.C. § 1398(i). See Section VI *infra*. Although the estate incurs no tax liability upon the abandonment, the debtor is likely to incur a taxable gain under section 1001 of the Internal Revenue Code upon a subsequent foreclosure by the creditor. Foreclosure constitutes a sale or other disposition of the property by the debtor, the "amount realized" under section 1001 includes indebtedness to which the property is subject, and the debtor succeeds to the estate's basis in the property under sections 1398(i) and 1398(g)(6) (the basis is typically low because of depreciation allowed or allowable).

Neither the Bankruptcy Code nor the Internal Revenue Code considers the federal tax implications of abandoning property before "termination of the estate," which may be considered to occur upon closing of the case. The position of most courts is that an abandonment of estate property to the debtor before the closing of the case is also a non-taxable event. An inference should not be drawn from section 1398(f)(2) that a transfer from the estate to the debtor is necessarily taxable merely because it occurs before "termination of the estate." In Samore v. Olson, 930 F.2d 6 (8th Cir. 1991), the court found no reason why abandonment during the administration of the case should have any different tax consequences than abandonment of property at the close of the bankruptcy case. The court in Olson specifically rejected the "fresh start" argument embraced later by a bankruptcy court in In re A.J. Lane & Co., 133 B.R. 264 (Bankr. D. Mass. 1991). The A.J. Lane court had held that the estate was liable for tax on the abandonment of property before the close of the case. The court's rationale included the following: "Taxing the Debtor on the foreclosure following this proposed abandonment creates a clear burden on the Debtor's fresh start, and there is no countervailing policy which overrides this consideration. Enhancement of the distribution to creditors is of course also a basic policy of bankruptcy law. But here creditors are not significantly prejudiced if the gain is considered that of the estate. The estate can use the large net operating loss carryover which it inherited from the Debtor." *Id.* at 274. The Ninth Circuit expressly rejected the A. J. Lane court's "fresh start" argument in In re Johnston, 49 F.3d 538 (9<sup>th</sup> Cir. 1995).

## **VI. COMPUTATION OF INDIVIDUAL'S TAX LIABILITY**

Gross income of the debtor realized after commencement of the bankruptcy case is treated under section 1398(e)(1) as gross income of the bankruptcy estate, and is not included on debtor's return. I.R.C. § 1398(e)(2). Deductions or credits treated under section 1398(e)(3) as deductions or credits of the bankruptcy estate are not allowable on debtor's return. I.R.C. § 1398(e)(3). Transfers, other than by sale or exchange, of assets from the individual debtor to the bankruptcy

estate are not treated as dispositions giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions. I.R.C. § 1398(f)(1). An individual debtor cannot carry back to a year preceding the year in which the case was commenced any net operating loss or credit carryback from a taxable year ending after commencement of the bankruptcy case. I.R.C. § 1398(j)(2)(B).

Upon termination of the bankruptcy estate, the debtor succeeds to specified tax attributes of the estate, including attributes that first arose during administration of the estate, such as net operating loss carryovers, capital loss carryovers, and credit and charitable contribution carryovers. I.R.C. § 1398(i). The phrase “termination of the bankruptcy estate” is not defined in the statute or regulations. In Benton v. Commissioner, 122 T.C. 353 (2004), the Tax Court held that termination occurred when the Chapter 11 plan was confirmed. This conclusion was based on the particular facts of the case and is now also questionable in light of the significant changes to the provisions governing individual Chapter 11 cases made by the BAPCPA. Under the BAPCPA, property of the estate in these cases is defined more broadly than under prior law (see discussion above of section 1115 of the Bankruptcy Code) and the debtor’s discharge is granted only upon completion of all plan payments when the debtor is an individual. See section 1141(d)(5)(A) of the Bankruptcy Code. (Under pre-BAPCPA law, the discharge was generally granted upon confirmation of the Chapter 11 plan.)

In a bankruptcy case to which section 1398 applies the federal income tax returns of the debtor for the taxable year in which the bankruptcy case is commenced and preceding years are open, on written request, to inspection by or disclosure to the trustee of the bankruptcy estate. In an involuntary case, however, no disclosure to the trustee can be made prior to the time the bankruptcy court enters an order for relief unless the court finds that such disclosure is appropriate for purposes of determining whether an order for relief should be entered. Debtor's prior year returns are open, on written request, to inspection by or disclosure to the trustee, only if the Service finds that the trustee, in a fiduciary capacity, has a material interest that would be affected by information contained in the return. I.R.C. § 6103(e)(4).

## **VII. PROCEDURAL PROVISIONS**

### **A. I.R.C. § 6503(h) - Suspension of Running of Period of Limitations**

Under section 6503(h), the running of the statute of limitations on collection provided by section 6502 is suspended for the period of time during which the Service is prohibited by reason of the bankruptcy case from making the assessment or from collection, plus six months thereafter. However, pursuant to

B.C. § 362(b)(9), the Service is no longer prohibited by the automatic stay from issuing a statutory notice or making an assessment. But see B.C. § 362(a)(8) and I.R.C. § 6213(f), discussed below.

#### **B. I.R.C. § 6213(f) - Coordination of Deficiency Procedures**

Section 6213(f)(1) provides that the 90-day or 150-day period prescribed by section 6213(a) for filing a Tax Court petition with respect to a deficiency is suspended for the period of time during which the debtor is prohibited by reason of a bankruptcy case from filing such petition, plus 60 days thereafter. Under B.C. § 362(a)(8) an individual debtor is prohibited by the automatic stay from commencing or continuing a Tax Court case concerning a prepetition tax liability. (The stay on Tax Court proceedings applies to both prepetition and postpetition corporate liabilities, so long as it is a liability that the bankruptcy court may determine.) If a statutory notice of deficiency is issued during the bankruptcy proceeding, or if the notice was issued before bankruptcy and the 90-day or 150-day period for filing a Tax Court petition had not expired when the bankruptcy case was filed, the period for assessing the tax is prolonged because the tax cannot be assessed until the taxpayer is given an opportunity to file a Tax Court petition with respect to the deficiency. For further explanation and examples, see Rev. Rul. 2003-80, 2003-2 C.B. 83.

**Note:** For cases filed before October 17, 2005, the B.C. § 362(a)(8) stay on Tax Court proceedings applies to any debtor with respect to a prepetition or postpetition tax liability

#### **C. I.R.C. § 7464 - Trustee of Debtor's Estate May Intervene in Tax Court Proceeding**

The trustee may intervene under I.R.C. § 7464, as a matter of right, on behalf of the estate, in any proceeding before the Tax Court in which the debtor is a party. This provision applies where the bankruptcy judge lifts the automatic stay under Bankruptcy Code § 362(a)(8) so that the debtor's prepetition liability can be determined in the Tax Court.

#### **D. I.R.C. § 6658 - Relief from Certain Penalties**

Under section 6658(a), the debtor or the estate may be relieved from penalties imposed by I.R.C. §§ 6651, 6654, or 6655 for failure to make timely payment of tax with respect to a period during which the bankruptcy case is pending. Rev. Rul. 2005-9, 2005-6 I.R.B. 470, clarifies the meaning of the term "pending." A Chapter 7 case is no longer "pending" when the court discharges the trustee and closes the case after the making of the final distribution and after receipt of the trustee's final report. A Chapter 11 case is no longer "pending" when it is closed.

This may occur shortly after payments commence under the plan. Alternatively, if the court does not close the Chapter 11 case shortly after payments commence, the case may be dismissed at some later time when there is a default in payment. The case is no longer “pending” when the order of dismissal is entered.