

What your tax preparer would like you to do when you file bankruptcy

Filing bankruptcy has several income tax effects.

First, a new taxpayer is created (a bankruptcy estate) when an individual or couple files either chapter 7 or 11 bankruptcy. Its “birthdate” is the date of bankruptcy filing. Any responsibility for filing a tax return for the bankruptcy estate lies with the trustee.

Your tax preparer needs to know if you file bankruptcy. There is an election to end your income tax year with the date of filing. This means you would file two part-year tax returns, one for the period from January 1 to the date of filing, the second from the date of filing to December 31.

Why might you consider this? (Other than you love your tax preparer and want to pay for TWO tax returns in one calendar year.) First, any tax carryovers that you have (capital losses, net operating losses, etc.) are available to offset your income in the first short year (before filing). If you do not make this election, all of the carryovers become property of the bankruptcy estate and cannot offset your income.

Second, if you owe tax for the short year (and cannot pay), that liability becomes a liability of the estate. If the estate does not pay, you will be liable after the termination of the bankruptcy estate.

Third, assets that are transferred to the bankruptcy estate carry their income tax effects. If you own a partnership or an S corporation, that income (or loss!) from the beginning of the year is the estate's income. (Be sure to let the preparer of partnership or corporate return that you have declared personal bankruptcy.) Dividends or interest earned are split – income received before the filing is the individual's, income afterwards is the estate's. Earnings (W-2 income) typically are taxed to the individual solely – though the estate may want the cash. Don't skimp on your withholdings!

Fourth, after the bankruptcy estate is wound up, tax benefits (capital losses, net operating losses) are distributed out of the estate back to the individual. Debt forgiveness income in the bankruptcy estate is not taxable to the estate or the individual. This income does have a cost – it reduces various tax attributes that carryout of the estate. If there are not tax attributes from the estate to offset the debt forgiveness income, it will reduce tax attributes of the individual. These tax attributes can include reducing the basis of personal property or real estate and requires the filing of a special IRS form, Form 982.

For instance: an individual declares bankruptcy. The only asset is a car worth \$2,000 with a cost of \$4,000. The estate has \$4,000 of debt forgiveness income. This is excluded from taxable income, but it carries a price – the tax basis of the car is reduced from \$4,000 to \$0. So any sale of the car will produce taxable income. This reduction is reported as ordinary income.

If you declare bankruptcy, request a copy of the bankruptcy estate's income tax return, initial inventory, and accounting. These documents will help your tax preparer calculate what carryover benefits or tax attribute reduction that may occur.

If the trustee did not file (and they will not if the income is less than \$9,000), request the initial inventory and the accounting. Your tax preparer will need these to estimate carryover benefits or tax attribute reduction that will affect you.

Fifth, you may receive various odd looking forms called either 1099-A or 1099-C. The 1099-C is used for debt forgiveness income from non recourse debts (including credit cards). The 1099-A is for debt forgiveness income from recourse debts.

When you receive these forms (and they are for the bankruptcy estate), make a copy for yourself and forward them to the bankruptcy estate. Give the copy of the 1099-A or 1099-C to your tax preparer but tell them that these debts are part of the estate. Your tax preparer will then be able to report this income and offset it as the responsibility of the estate.

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