

# FINANCIAL DISTRESS

## ISSUE 1: FINANCIAL DISTRESS

Producers often face significant income tax consequences from financial distress transactions. The two most common income tax consequences from these transactions are:

1. the recognition of gain or loss from transfer of assets, and
2. discharge of indebtedness income.

### Recognition of Gain or Loss From the Transfer of Assets

The rules that require the recognition of gain or loss as a result of transferring assets in financial distress are the same as those that apply to transfers outside of financial distress.

#### Example 1.

Les Filling owns the following assets with the characteristics listed. The table also shows the gain or loss that must be reported if the asset is sold this year.

Asset	Date Acq'd	Cost or Other Beginning Basis	Deprec'n Method	Deprec'n Claimed	Adjusted Basis	Fair Market Value	Gain or Loss
Land	5/10/1971	\$160,000	N/A	\$0	\$160,000	\$640,000	\$ 480,000
Single Purpose Livestock Structure	5/15/1999	\$400,000	MACRS 150% DB 10 yrs	\$ 277,640	\$122,360	\$ 200,000	\$ 77,640
Machine Shed	6/20/1997	\$ 60,000	MACRS SL 20 yrs	\$ 24,000	\$ 36,000	\$ 50,000	\$ 14,000
Other Bldgs	5/10/1971	\$200,000	SL	\$ 200,000	\$0	\$ 40,000	\$ 40,000
Machinery	Various	\$600,000	MACRS 150%DB	\$ 450,000	\$150,000	\$ 225,000	\$ 75,000
Herd of Dairy Cows	1/12/2003	\$200,000	MACRS 150% DB	\$ 166,680	\$ 33,320	\$ 150,000	\$ 116,680
Dairy Calves (raised)	3/2006	\$0	N/A	\$0	\$0	\$ 50,000	\$ 50,000
Grain	Fall 2006	\$0	N/A	\$0	\$0	\$ 350,000	\$ 350,000
<b>TOTAL</b>		<b>\$1,620,000</b>		<b>\$1,118,320</b>	<b>\$501,680</b>	<b>\$1,705,000</b>	<b>\$1,203,320</b>

If Les sold all of his assets in 2007 he would have to report the following income:

	Sch. F	Form 4797 Deprec'n Recapture	Form 4797 15% Capital Gain	Form 4797 25% Capital Gain	TOTAL
Land			\$480,000		\$ 480,000
Single Purpose Livestock Structure		\$ 77,640			77,640
Machine Shed				\$14,000	14,000
Other Bldgs.				40,000	40,000
Machinery		75,000			75,000
Beef Cows		116,680			116,680
Beef Calves	\$ 50,000				50,000
Grain	350,000				350,000
<b>TOTAL</b>	<b>\$400,000</b>	<b>\$269,320</b>	<b>\$480,000</b>	<b>\$54,000</b>	<b>\$1,203,320</b>

Assuming Les and his wife have no other income and they file a joint return claiming the standard deduction and two personal exemption deductions, their income and self-employment tax liability for 2007 would be as follows:

Income tax on ordinary income	\$226,736
Self-employment tax	20,683
Income tax on 15% capital gains	72,000
Income tax on 25% capital gains	13,500
<b>TOTAL</b>	<b>\$332,919</b>

### Example 2.

Assume the same facts as in Example 1. Les has \$1,700,000 of debt and his lenders will not give him a loan to put in his year 2007 crop. Les uses the cash method of accounting. The following table shows Les' debt, the basis of his assets, the fair market value of his assets and the gain or loss that he must report if he transfers those assets. Les is current on his debt payments, so none of the debt is interest—it is all principal.

Asset	Debt	Adjusted Basis	Fair Market Value	Gain or Loss
Land & Improvements	\$1,250,000	\$ 318,360	\$ 930,000	\$ 611,640
Machinery	250,000	150,000	225,000	75,000
Livestock & Grain	200,000	33,320	550,000	516,680
<b>TOTAL</b>	<b>\$1,700,000</b>	<b>501,680</b>	<b>\$1,705,000</b>	<b>\$1,203,320</b>

**Question 1.** What are the tax consequences of Les selling all of his assets in 2007 and using the proceeds from the sale to pay his debts?

**Answer 1.** Les has the same consequences from the sale of assets as shown above. Using the proceeds to repay the principal debt does not change the income tax result. Therefore, assuming Les has the same itemized and personal exemption deductions as in Example 1, Les will owe \$332,919 in income and self-employment taxes if he sells all of his assets in one tax year and uses the proceeds to pay principal.

**Observation.** After paying his \$1,700,000 of debt, Les will have only \$5,000 of the sale proceeds left to pay his \$332,919 of tax liability.

### Payment of Interest

If the taxpayer uses the cash method of accounting and uses proceeds from the sale of assets to pay accrued interest, the interest payment can be deducted.

**Question 2.** If \$100,000 of the \$1,700,000 debt that Les pays with the proceeds from the asset sales were accrued interest instead of principal, would his income tax consequences be different?

**Answer 2.** Yes. Since Les uses the cash method of accounting, he can deduct the \$100,000 of interest that he pays with the proceeds of the asset sales. That deduction will reduce his income and self-employment tax liability by \$41,779 to \$291,140.

### Discharge of Debt

Creditors of financially distressed taxpayers sometimes forgive some or all of the taxpayer's debt because the taxpayer is unable to pay or because the cost of collecting the debt is more than the debt. For income tax purposes, if the creditor forgives debt for any reason other than for the purpose of making a gift to the debtor, the discharged debt is treated as income to the debtor unless one of the following exceptions applies:

1. If the taxpayer had paid the debt that was discharged, the taxpayer would have been allowed to deduct the amount paid [IRC §108(e)(2)].
2. The debtor was in bankruptcy at the time the debt was discharged. [IRC §108(a)(1)(A)].
3. The debtor was insolvent at the time the debt was discharged [IRC §108(a)(1)(B)].
4. The seller of property under an installment contract discharged the debt and the original purchaser under the contract owed the debt discharged [IRC §108(e)(5)].

5. The debt discharged is qualified farm indebtedness [IRC §108(a)(1)(C)].
6. The debtor is not a C corporation and the debt discharged is qualified real property business indebtedness. [IRC §108(a)(1)(D)].

**Practitioner Note.** If discharged debt qualifies for more than one of the above exceptions, the first applicable exception in the preceding list is applied to the discharged debt.

### Example 3.

Assume the same facts as in Example 1 except that Les Filling has \$1,850,000 of debt of which \$100,000 is accrued interest owed to Second State Bank, which holds a second mortgage on Les' real estate. The agreement between Les and the Second State Bank applies payments on the loan first to accrued interest and then to principal. The debt owed to Second State Bank is qualified farm indebtedness. Since Second State Bank is unlikely to collect all of the debt Les owes, it has agreed to forgive \$150,000 of Les' debt in 2007.

**Question 3.** What are the income tax consequences of the \$150,000 debt discharge?

**Answer 3.** Because payments are applied first to accrued interest, the first \$100,000 of debt discharge is treated as a discharge of the \$100,000 of accrued interest. Since that interest would have given Les a \$100,000 deduction if it had been paid, the first exception in the above list applies and the discharge of that \$100,000 is not income to Les.

After the \$100,000 of interest is discharged, Les has \$1,750,000 of debt and \$1,705,000 of assets, so he is still insolvent by \$45,000. Consequently, the next \$45,000 of debt discharge qualifies for the third exception in the above list and Les does not have to include that discharged debt in income.

The remaining \$5,000 of the \$150,000 discharged debt is discharge while Les is solvent. Since it is qualified farm indebtedness, the discharge of this \$5,000 qualifies for the fifth exception in the above list and Les does not have to report it as income if he has enough tax attributes to pay the price for not reporting the \$5,000 as income. See discussion of paying the price below.

In summary, all of the discharged debt potentially qualifies for an exception to the rule that it must be reported as income. The amount that qualifies for each exception is as follows:

Exception	Amount
Deductible if paid	\$100,000
Insolvent	\$ 45,000
Qualified farm debt	\$ 5,000
<b>TOTAL</b>	<b>\$150,000</b>

**Practitioner Note.** The IRS has reversed its position on the treatment of exempt assets for purposes of calculating a taxpayer's solvency. In Ltr. Rul. 9125010 it had taken the position that the value of assets that were exempt from the reach of creditors under state law was not included in calculating a taxpayer's solvency. On August 13, 1999, the IRS released Ltr. Rul. 199932013, in which it revoked Ltr. Rul. 9125010 and held that the value of exempt assets is included.

### Paying the Price

In most cases, the taxpayer must pay a price for not recognizing discharge of indebtedness income. The price is a reduction of the taxpayer's following tax attributes:

1. NOL. Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.
2. General Business Credit. Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under I.R.C. §38 (relating to general business credit).
3. Minimum Tax Credit. The amount of the minimum tax credit available under I.R.C. §53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.
4. Capital Loss Carryovers. Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under I.R.C. §1212.
5. Basis Reduction. The basis of the property of the taxpayer. See I.R.C. §1017.
6. Passive Activity Loss and Credit Carryovers. Any passive activity loss or credit carryover of the taxpayer under I.R.C. §469(b) from the taxable year of the discharge.
7. Foreign Tax Credit Carryovers. Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under I.R.C. §27.

### Order

The general rule is that the tax attributes are reduced in the order listed above [I.R.C. §108(b)(2)]. However, the taxpayer can elect to reduce the basis in depreciable property first [IRC §108(b)(5)].

### Example 4.

Assume that Les in Example 3 had the following tax attributes carried into his 2007 tax year and that Second State Bank discharged the same \$150,000 of debt as in Example 3.

NOL	\$ 15,000
Capital loss carryover	\$ 10,000
Bases	\$501,680

**Question 4.** What tax attributes does Les reduce as a result of the discharged debt?

**Answer 4.** Les does not have to reduce tax attributes for the \$100,000 of accrued interest that was discharged. He has in effect already paid that price by not getting a deduction for payment of the interest.

The \$45,000 that was excluded from income under the insolvency exception requires Les to reduce tax attributes. If Les does not make the election to reduce the basis of depreciable property first, he must reduce his NOL and capital loss carryover to zero as shown in the following table:

Attribute	Amount Before Attribute Reduction	Attribute Reduction	Amount After Reduction	Balance of Discharged Debt
				\$45,000
NOL	\$15,000	\$15,000	\$0	\$30,000
Capital Loss	\$10,000	\$10,000	\$0	\$20,000

Les does not have to pay the price for the remaining \$20,000 of discharged debt that was excluded under the insolvency exception. That is a result of the limit on bases reduction discussed below.

The \$5,000 that was reduced under the qualified farm indebtedness exception requires Les to reduce the bases in his assets by \$5,000. Therefore, the discharge of debt reduces Les' bases in assets are \$496,680.

### Limit on Bases Reduction

If the debt discharge is excluded from income under the bankruptcy or insolvency exception, there is a limit on the reduction of the aggregate bases in the taxpayer's assets. The aggregate of the bases in the taxpayer's assets is reduced only down to the remaining debt after the discharge [I.R.C. §1017(b)(2)].

In Example 3 above, Les had \$1,700,000 of debt after the discharge and only \$501,680 of bases in assets (before the reduction for discharge of indebtedness). Therefore, he was not required to reduce bases for the \$20,000 of discharged debt that was excluded by the insolvency rules since his bases in assets are already below his remaining debt.

### Timing

The attribute reduction occurs after the taxes have been computed for the year of the discharge. Therefore, the attributes are used on the tax return before they are subject to the reduction under the discharge of indebtedness rules.

### Example 5.

Assume the same facts as in Example 4. If Les sold his "other buildings" in 2007 (\$40,000 fair market value, zero basis), he could use the \$15,000 NOL and \$10,000 capital loss carryover to offset part of the \$40,000 long-term capital gain that he must recognize from the sale of the buildings. If he waits until 2007 to make the sale, he will have no NOL or capital loss carry forward to offset the gain because they will be absorbed by the reduction required under the discharge of indebtedness rules. His basis in the buildings will also be reduced slightly by the portion of the \$5,000 bases reduction that is allocated to the bases in the buildings.

## ISSUE 2. PLANNING FOR BANKRUPTCY

Many farm producers do not think about income tax planning when they are in financial distress because they assume income taxes are the least of their problems. In fact, there are significant income tax planning opportunities for farmers who are in financial distress and are thinking about filing for bankruptcy. Some of the planning opportunities are outlined below.

### Control Timing of Discharge and Transfer

Because the reduction of attributes is done *after* the taxes are calculated for the year of the discharge [I.R.C. §108(b)(4)(A)], it is important to pay attention to the timing of the discharge of indebtedness and the transfer of assets.

1. The gain realized on a transfer that occurs in the same tax year as a discharge of indebtedness will be offset by attributes carried to that year *before* the attributes are reduced because of the discharge of indebtedness. *Note.* The order of the transfer and the discharge within the year does not matter.

#### Example 1.

Because Farmer Peach was unable to pay his debts, his bank discharged \$125,000 of debt on December 1, 2007. Peach was insolvent both before and after the discharge. The only tax attribute other than basis that Peach carried into 2007 was \$125,000 of net operating loss. Up to December 1, 2007, he had no other taxable income or loss.

Peach plans to sell 160 acres of land for \$160,000 to help pay off debt. His basis in the land is \$60,000.

If Peach waits until 2008 to sell the land, the discharge of debt in 2007 will absorb all of his net operating losses before they can be used to offset the gain on the sale of his land. Therefore, Peach will be required to include the \$100,000 gain on the sale of the land in his 2008 income.

If Peach sells his land in 2007, the net operating loss will be applied first to the sale of the land. Therefore, Peach can offset the \$100,000 of income realized from the sale of the land with \$100,000 of the \$125,000 of net operating loss. The discharge of indebtedness will require Peach to reduce his remaining net operating loss to zero.

2. The reduction of basis under I.R.C. §108(b)(2)(E) and (c)(1)(A) is treated the same as a deduction for depreciation for purposes of I.R.C. 1245 and 1250. I.R.C. 1017(d).

#### Example 2.

Farmer Pear's bank discharged \$50,000 of debt on December 10, 2007. Pear had used the proceeds of this loan to purchase a combine, and the combine was used as collateral for the loan. Pear paid \$60,000 for the combine in 2003 and will claim \$26,922 of depreciation on it through 2007, leaving her a \$33,068 adjusted basis at the end of 2007. Pear was insolvent both before and after the discharge but had no tax attributes at the end of 2007 other than \$100,000 basis in assets. Her debt after the discharge was \$40,000.

Because her basis in all assets exceeds her debt by \$60,000 (\$100,000 - \$40,000), she must pay the full price for not recognizing the \$50,000 of discharge of indebtedness income by

reducing her basis in assets by \$50,000. She first reduces her basis in the combine from \$33,068 to zero [Treas. Reg. §1.1017-1(a)(2)]. She then reduces the basis of other business assets by the remaining \$16,932 of the \$50,000 debt discharge.

Pear plans to sell the combine for \$40,000.

If Pear waits until 2008 to sell the combine, she will have a basis of zero in the combine at the time of sale. Therefore, she will have to recognize \$40,000 of gain and treat all of the gain as the recapture of depreciation under I.R.C. §1245.

If Pear makes the sale in 2007, she will have a basis of \$37,577 (\$33,068 plus one-half of the 2002 depreciation (\$4,509)) and will be required to report only \$2,423 of gain on the sale.

**Observation.** The sale in 2008 would have allowed Pear to claim the additional \$4,509 of depreciation in 2007.

The discharge of indebtedness requires Pear to reduce her basis in assets as of the first day of the 2008 tax year. However, the sale of the combine reduced her 2007 ending aggregate basis to \$66,932 (\$100,000 - \$33,068). Therefore, her aggregate basis now exceeds her debt by only \$26,932 (\$66,932 - \$40,000). Consequently, she will only be required to reduce her basis by \$26,932. The remaining \$13,068 (\$40,000 - \$26,932) discharge of indebtedness is tax free.

### **Declaration of Bankruptcy**

One of the choices that a farmer in financial distress has is whether or not to declare bankruptcy. Unlike individuals in other households, a farmer cannot be forced into bankruptcy by his or her creditors [11 U.S.C. §303(a) and §1307(a)].

1. The income tax effect of declaring bankruptcy is that slightly different rules apply to debt that is discharged in bankruptcy than to debt that is forgiven while the debtor is not in bankruptcy.
  - a. All debt that is forgiven in bankruptcy qualifies for the I.R.C. § 108 rule that it does not have to be reported as income [I.R.C. §108(a)(1)(A)].
  - b. If the debtor is not in bankruptcy when debt is forgiven, the forgiven debt is treated the same as debt discharged in bankruptcy only so long as the debtor is insolvent when the debt is forgiven. I.R.C. §108(a)(1)(B).

### **Example 3.**

For example, assume a taxpayer has \$525,000 of debts and \$400,000 of assets. If \$200,000 of debts are discharged in bankruptcy, none of the discharge will have to be reported as income. If the same \$200,000 of debt is forgiven outside of bankruptcy, only the first \$125,000 of debt forgiven will be treated like the debt discharged in bankruptcy. The other \$75,000 of debt will be subject to the "qualified farm indebtedness" rules [I.R.C.108(a)(1)(C)].

2. The qualified farm indebtedness rules provide the same tax benefits as the bankruptcy rules in some cases. However, the qualified farm indebtedness rules differ from the bankruptcy rules in four respects.

- a. First, all debts discharged in bankruptcy qualify for the nonrecognition exception of I.R.C. §108. The qualified farm indebtedness rules require the debt to have been incurred for the purchase of assets used in the farm business. I.R.C. §108(g)(2)(A). This requirement should pose no problem for most farmers.
- b. The second difference is that the qualified farm indebtedness rules require the taxpayer to reduce the basis of land last.
- c. The third difference can have a significant effect in some cases. In the case of bankruptcy and insolvency, discharged debt does not have to be recognized as income even if there are no tax attributes to be reduced. The qualified farm indebtedness rules allow forgiven debt to avoid recognition as income only to the extent of the debtor's tax attributes [I.R.C.108(g)(3)]. Beyond that amount, the debtor must include forgiven debt in income.
- d. Fourth, in the case of bankruptcy or insolvency, the debtor's basis in all of his or her assets cannot be reduced below his or her total debts after the discharge [I.R.C. §1017(b)(2)].

The combination of these rules means that the qualified farm indebtedness rules require some debtors to recognize more income and pay a higher price for the income that is recognized.

#### **Example 4.**

To illustrate these differences, assume a taxpayer has \$400,000 of qualified farm indebtedness, \$300,000 fair market value of assets, \$75,000 of net operating losses and \$50,000 of basis in depreciable assets. If \$175,000 of debt is discharged in bankruptcy, no income will have to be reported and the taxpayer's \$75,000 of net operating loss will be reduced to zero. The difference between the debt discharged and the tax attribute reduction ( $\$175,000 - \$75,000 = \$100,000$ ) will never have to be included in income.

By contrast, if the same \$175,000 of debt is forgiven outside of bankruptcy, the first \$100,000 will be treated under the insolvency rules. The debtor would not have to report that \$100,000 as income but would have to reduce net operating losses to zero. The basis of the depreciable assets would not be reduced as a result of the forgiveness of the first \$100,000 of debt since the insolvency rules do not require a reduction of basis below the total debt after the forgiveness. The next \$75,000 of debt that is forgiven is subject to the qualified farm indebtedness rules because the debtor was no longer insolvent when that debt was forgiven. Under those rules, the basis in the debtor's depreciable assets is reduced to zero. The remaining \$25,000 of debt must be reported as income.

Therefore, by choosing bankruptcy, the debtor can avoid the recognition of all the income and loses only \$75,000 of tax attributes. If bankruptcy is not chosen, the debtor must recognize \$25,000 of income and loses \$125,000 of tax attributes.

#### **Reduce the Basis of Depreciable Assets First**

In the case of debts discharged in bankruptcy or debts forgiven while the debtor is insolvent, the debtor has a choice about how to pay the price for the non-recognition of income.

1. One option is to pay the price by reducing the following tax attributes in the order listed [I.R.C.108(b)(1)].
  - a. Net operating losses
  - b. General business credits (credit reduced by \$1.00 for \$3.00 of debt discharged)

- (1) Regular investment credit
  - (2) WIN credit
  - (3) Jobs credit
  - (4) Alcohol fuel credit
  - (5) Investment credit for research expenditures
- c. Minimum tax credit
  - d. Capital loss carryovers
  - e. Basis of assets (but not below the total debt of the debtor after the forgiveness)
  - f. Passive activity loss and credit carryovers
  - g. Foreign tax credit carryovers
2. The other option is to reduce the basis of depreciable assets of the debtor first [I.R.C.108(b)(5)].
    - a. If that reduction in basis does not absorb all of the discharged debt, the other attributes must be reduced beginning at the top of the list.
    - b. The debtor can elect to pay part of the price by reducing basis first and then switch back to the top of the list of attributes.
    - c. The election to reduce basis first is made on a Form 982 filed with the taxpayer's return for the year in which the debt is discharged [I.R.C.108(d)(9)(A)].
  3. The option that is chosen by a debtor will make a difference only if there will be some tax attributes remaining after all the discharged debt is absorbed. In that case, the option that is best for the debtor will depend upon the pattern of his or her income in the succeeding years.
    - a. The advantage of electing to reduce the basis of depreciable property first is that other tax attributes such as net operating losses or investment credit that will provide a tax benefit in the following year may be preserved. The basis in depreciable property provides a tax benefit that is spread over the depreciable life of the assets. Preserving the other tax attributes will not be an advantage if the debtor's income will be higher in later years when the depreciation could be claimed.

**Example 5.**

To illustrate the effect of this election, assume a debtor has \$10,000 of debt forgiven while she is insolvent. Her only tax attributes are \$10,000 of net operating loss carryovers and \$20,000 of basis in depreciable assets that have three years of depreciable life remaining. She has \$15,000 of total debt after the forgiveness. She expected to have \$60,000 of taxable income in each of the three years following the discharge.

It would be to her advantage to elect to reduce the basis of depreciable assets first. By doing so, she preserves \$10,000 of net operating loss carryover that will reduce her taxable income in the next year. If the election were not made, there would be no net operating loss deduction in the following year but the depreciation deduction would be increased by \$3,333 in each of the three years following the discharge. Since the deductions are all in the same bracket, the net operating loss deduction is of greater value to the debtor because it accelerates the \$10,000 deduction and therefore postpones the payment of tax.

If the debtor expected \$10,000 of taxable income the year after the forgiveness of debt and \$60,000 of taxable income in the two succeeding years, it would not be to her advantage to

elect to reduce the basis of depreciable property first. Making the election would preserve the net operating loss carryover which would be claimed as a deduction from the \$10,000 of taxable income in the year following the forgiveness. Since that income is taxed at the rate of 15 percent while the \$3,333 of income that would be offset by a depreciation deduction in each of the following years would be taxed at the rate of 28 percent, the deduction is of greater value to the debtor in the later years.

- b. The disadvantage of electing to reduce the basis of depreciable assets first is that the limit on reduction in basis (i.e., the rule that the debtor's basis in all assets cannot be reduced below the debtor's total indebtedness after the forgiveness of debt) will not apply to the reduction of the debtor's basis in depreciable property [I.R.C. §108(b)(5)(B)]. Therefore, the election could increase the price paid by the debtor for the non-recognition of income.

### **Example 6.**

If the debtor in the previous example had only \$4,000 of net operating loss carryovers and \$20,000 of basis in depreciable assets, she would forgo \$1,000 of tax attributes by electing to reduce the basis of depreciable assets first.

Without the election, she must reduce her net operating loss carryovers to zero and her basis in depreciable assets to \$15,000.

With the election, she must reduce the basis of her depreciable assets to \$10,000 and she preserves only \$4,000 of net operating loss carryover. The cost of losing this \$1,000 of deductions may be less than the cost of deferring the deductions by using up the net operating loss carryover.

### **Two Short Tax Years**

If the debtor elects to declare bankruptcy under either chapter 7 or 11 of the Bankruptcy Code and has property that is not exempt, he or she will have two options with respects to choosing a tax year.

1. One option is to continue with the same tax year that would have been used if there were no bankruptcy.
2. The other option is to divide the tax year that would have been used if there were no bankruptcy into two short years [I.R.C. §1398(d)].
  - a. The first of the short years ends the day before bankruptcy.
  - b. The second short year begins on the day of bankruptcy.
  - c. The election of two short years must be made by the 15th day of the fourth month following the end of the first short year [I.R.C. §1398(d)(2)(D)].
  - d. A separate return must be filed for each of the short years [I.R.C. §1398(d)(2)(E)].
  - e. The debtor's income in each of the two short years must be annualized [I.R.C. §§443 and 1398(d)(2)(F)].
3. The option that is chosen may have an effect on whether the debtor or the bankruptcy estate pays the taxes, on when and how much of the debtor's tax attributes are absorbed, and on the self-employment taxes that are imposed on the debtor.
  - a. **Who Pays the Taxes.** Because the bankruptcy estate is responsible for all of the debtor's liabilities at the time of bankruptcy, income taxes that accrue before the date

of bankruptcy become a debt of the estate. 11 U.S.C. §§502(b) and 507 (a)(6)(A). Consequently, the election to end a tax year before the day of bankruptcy will cause the taxes on the income earned to that point in time to become a debt of the bankruptcy estate.

- (1) Because income taxes are a priority item in bankruptcy, they will be paid before other debts that may be discharged. 11 U.S.C. §507(a)(6)(A).
- (2) If the election of two short years is not made, the tax on the income earned during the debtor's tax year in which bankruptcy occurs will accrue after the date of bankruptcy and will therefore not become a debt of the estate.

#### **Example 7.**

To illustrate, assume a farmer who is a calendar year taxpayer is in financial difficulty and sells some assets in January to pay debts. On the first of March he decides to declare bankruptcy. If he does not elect two short tax years, the gain he realized on the sale of the assets will be included on the return he files for the full year. Those taxes will not be a debt of the bankruptcy estate. If he elects two short tax years, the income taxes on the gain from the sale of the assets will accrue before bankruptcy was declared. Therefore, the taxes on the gain will become a debt of the bankruptcy estate.

- (3) If the debtor has a loss during the first short year, electing two short years will deprive him or her of using the loss in the first short year to offset income in the second short year.

**b. Absorption of Attributes.** The debtor's selection of a single tax year or two short tax years will also affect the amount of tax attributes that pass from the debtor to the bankruptcy estate.

- (1) The rule is that the bankruptcy estate receives the tax attributes of the debtor as of the beginning of the tax year in which bankruptcy occurred [I.R.C. §1398(g)].
  - (a) Therefore, if the debtor chooses a single tax year, the attributes that he or she has at the beginning of that year will pass to the bankruptcy estate and cannot be used by the debtor on the tax return for that year.
  - (b) If the debtor chooses two short tax years, the attributes do not pass to the bankruptcy estate until the beginning of the second short year. Therefore, the debtor can apply the tax attributes on his or her return for the first short year.
- (2) When the bankruptcy estate is closed, any remaining attributes pass back to the debtor [I.R.C. §1398(i)].
  - (a) Therefore, the amount of attributes that is absorbed by the bankruptcy estate has some effect on the debtor.
  - (b) The debtor cannot carry the tax attributes from a post-petition year back to a tax year prior to the date of bankruptcy [I.R.C. §1398(j)(2)].
- (3) If the debtor has income before the date of bankruptcy, it is usually to the debtor's advantage to choose two short years.

- (a) By doing so, the debtor not only makes the taxes on that income a debt of the estate but can use the tax attributes before they are passed to the bankruptcy estate to reduce the amount of taxes owed on that income.
- (b) If the estate has enough assets to pay the taxes due for the first short year, the reduction in taxes benefits the unsecured creditors of the debtor. If the estate does not have enough assets to pay the tax due for the first short year, the reduction of taxes is a benefit to the debtor because the taxes will not be discharged in bankruptcy [11 U.S.C. §523(a)(1)(A)] and will become a debt of the debtor when the bankruptcy estate is closed.
- (c) The cost to the debtor of applying the tax attributes to his or her own return by electing two short years is a potential reduction in the amount of tax attributes that pass from the bankruptcy estate back to the debtor when the estate is closed.
- (d) If the bankruptcy estate would absorb all the tax attributes anyway, the use of the attributes in the debtor's first short year will have no effect on the attributes that are passed back to the debtor.

**c. Self-employment Taxes.** The choice of two short years could increase the amount of self-employment taxes that are imposed on the debtor.

- (1) The full base income amount will be applied in each of the two short years (*Rev. Rul. 69-410*, 1969-2 C.B.167). Therefore, if the debtor's total wage and self-employment income for the two short years is more than the base amount for that calendar year, more self-employment tax will be imposed by choosing two short years than by choosing a single tax year.
- (2) The burden of the extra self-employment tax may not fall on the debtor. As noted above, the taxes due for the first short tax year are a debt of the bankruptcy estate. If those debts are paid by the bankruptcy estate out of assets that would not pass to the debtor anyway, then the extra tax is not a burden to the debtor.

**Example 8.**

To illustrate, assume a farmer sells \$80,000 of zero basis grain in January, 2007. On March 1, 2007, she declares bankruptcy and finds a job in town that pays her \$10,000 of wages for the rest of the year. If she chooses one tax year, the \$10,000 of wages will reduce her self-employment income base to \$66,200 so that her self-employment tax would be \$10,352 (12.4% of \$66,200 = \$8,209 plus  $2.9\% \times \$80,000 \times .9235 = \$2,143$ ). If she chooses two short tax years, her self-employment income base will be the full \$76,200 for the first of the two short years. Therefore, she will pay \$11,592 (12.4% of \$76,200 = \$9,449 plus  $2.9\% \times \$80,000 \times .9235 = \$2,143$ ) in self-employment taxes. Under either option, the FICA tax on her wages will be \$765 (7.65% of \$10,000). Therefore, the two short years option increases her total social security taxes by \$1,240 (\$11,592 minus \$10,352).